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OF HUNGRY WOLVES AND HORIZONTAL CONFLICTS: RETHINKING THE JUSTIFICATIONS FOR BANK HOLDING COMPANY LIABILITY

Eric J. Gouvin*

To what extent should bank holding companies bear the costs of bank failure? Current banking law provides a number of ways to impose liability on bank holding companies for bank failure. Those devices, however, have developed haphazardly and sometimes rest on inconsistent theoretical foundations. Professor Gouvin critiques the regulatory justifications that have been offered for holding company liability and offers an alternative justification for imposing liability on holding companies based on the idea that directors of bank subsidiaries suffer from an especially difficult form of horizontal conflict—the situation where the board of directors owes several different duties and chooses to serve shareholder interests to the exclusion of all others, including their duty to the bank as an entity. He resolves the horizontal conflict through the application of agency-like principles. The quasi-agency approach would treat subsidiary directors as quasi agents of the parent company and impose responsibility directly on the holding company for any duties that bank managers owe to parties other than the bank holding company (including the duty to act in the best interest of the bank as an entity). Under the quasi-agency approach, the holding company should be liable only to the extent that the directors of its properly capitalized bank failed to discharge duties to nonparent constituents (including any duty to the bank itself as a separate legal entity). The extent of the liability so incurred should be limited to the harm caused by the failure to discharge the duty.

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I. INTRODUCTION

The financial services marketplace is in the midst of profound change, and the role of bank holding companies within the banking industry is changing rapidly as well. Historically, bank holding companies have been employed as a way to deal with restrictions on branching or interstate ownership of banks or as a way to circumvent restrictions on permissible bank activities.¹ Today, those familiar reasons for holding company formation are much less important. Virtually all states now permit statewide branching,² so holding companies are no longer needed for that purpose. Similarly, federal law now permits nationwide interstate branching,³ thereby negating the requirement that holding companies operating in several states have a bank chartered in each state.⁴ In addition, the Comptroller of the Currency's authorization of operating subsidiaries for national banks⁵ makes the holding company structure less important as a way to get around restrictions on bank activities.⁶

Yet even with all these changes, bank holding companies continue to play a key role in the banking industry and will continue to do so for some time to come. Part of the reason for the continuing vitality of bank holding companies is that the traditional reasons for forming them have not disappeared completely. For example, banking organizations that plan to conduct business in Texas and Montana will need the holding company device to conduct operations outside those states.⁷ Similarly, state-chartered banks not desiring to convert to a national charter may need to maintain their holding company struc-

1. See Robert Charles Clark, *The Regulation of Financial Holding Companies*, 92 HARV. L. REV. 787, 816-17, 822-23 (1979) (noting that bank holding companies have been employed as a means to achieve branching where states had restrictive branching laws, interstate ownership when that was not permitted by law, and entry into businesses "closely related" to banking).

2. As of the end of 1994, there were no more unit banking states and only two states did not permit branching on a statewide basis. See Dean F. Amel, *Trends in the Structure of Federally Insured Depository Institutions, 1984-94*, 82 Fed. Res. Bull. 1, 3 (Jan. 1996).

3. See Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338 (codified as amended in scattered sections of 12 U.S.C.).

4. Only Texas and Montana have opted to delay the Riegle-Neal branching provisions. Texas has delayed interstate branching until September 1999, and Montana has postponed it until October 2001. See Bill McConnell, *Interstate Starts Sunday; Impact Will Take Longer*, AM. BANKER, May 30, 1997, at 2, 2 (noting the decision to delay in Texas and Montana).

5. The Comptroller of the Currency has promulgated a regulation that permits national banks to form operating subsidiaries that may engage in several new activities, such as equipment leasing, insurance, real estate brokerage, real estate development, and securities underwriting. See Rules, Policies, and Procedures for Corporate Activities, 61 Fed. Reg. 60,342, 60,349 (1996) (to be codified as 12 C.F.R. pts. 3, 5, 7, 16, 28). Given that most states have parity or "wild card" statutes that by law grant their state-chartered institutions powers at least as liberal as the powers given to national banks, the extent of liberalized banking powers in the banking system as a whole is quite extensive. See CONFERENCE OF STATE BANK SUPERVISORS, A PROFILE OF STATE CHARTERED BANKING 156-58 (1996).

6. See McConnell, *supra* note 4, at 2 (noting that some banks plan to convert to a national charter, establish operating subsidiaries, and shed their holding company structure).

7. This is the situation with Chase Manhattan Corp., for example, which owns Texas Commerce Bank in Houston. See *id.*

tures to engage in certain activities.⁸ Other banking organizations may decide to keep the holding company structure for the same reasons that nonbanking firms choose to organize that way.⁹ Finally, changes in the Federal Reserve's approach to holding company activities may make the holding company structure attractive enough to outweigh the benefits of converting to a national bank with operating subsidiaries.¹⁰

8. For example, First Union Corp. of Charlotte will consolidate 12 of its 13 banks into one charter but will keep its separately chartered Delaware bank to take advantage of the insurance powers it possesses. See Brett Chase, *As Milestone Nears, Banks Prepare to Centralize*, AM. BANKER, May 15, 1997, at 4, 4.

9. Norwest, for example, has 41 charters under its bank holding company structure, but other than consolidating the Texas banks under one charter, has no plans for additional consolidation. See *id.* Similarly, Fifth Third Bancorp of Cincinnati has no plans to merge its 11 bank charters into one. See *id.* Banking organizations may decide to utilize the holding company form instead of the consolidated bank with operating divisions approach for reasons unrelated to banking regulation. For a traditional view of the rather inconsequential managerial aspects of the subsidiary/division distinction in the nonbanking context, see Robert W. Murphy, *Corporate Divisions vs. Subsidiaries*, HARV. BUS. REV., Nov.-Dec. 1956, at 83, 83 (drawing conclusions as to potential advantages one form of organization might provide over the other for managerial consideration). On the matter of why firms establish subsidiaries, see CHESTER ROHRlich, ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES § 12.02, 508-15 (4th ed. 1967) (citing various legal reasons for subsidiary formation such as to limit liability, to avoid restrictions in the parent's charter or restrictions arising under law, for tax reasons, and for purposes of avoiding complications arising from "foreign corporation" status; also citing nonlegal reasons such as increasing the morale of the subsidiary's management, to settle shareholder disputes, and public relations purposes); and compare Joseph H. Sommer, *The Subsidiary: Doctrine Without a Cause?*, 59 FORDHAM L. REV. 227, 259-73 (1990) (citing use of the subsidiary device as an effective method for controlling choice of law and venue).

10. By statute, bank holding companies are allowed to participate in activities "closely related" to banking provided those activities produce public benefits. See 12 U.S.C. § 1843(c)(8) (1994). The Federal Reserve Board has promulgated Regulation Y to specify that "closely related" activities include such things as acting as an investment advisor to mutual funds, leasing property, providing data-processing services, providing courier services, performing real estate appraisals, providing investment advice on financial futures and options, and providing tax preparation services. See 12 C.F.R. § 225.125 (1998). Bank holding companies are now permitted, among other things, to provide discount brokerage services, see Securities Indus. Ass'n Board of Governors of the Fed. Reserve Sys. (Schwab), 468 U.S. 207 (1984); Investment Advisor Activities, 12 C.F.R. § 225.125(h), and to underwrite (on a limited basis) mortgage-backed securities, see Citibank, 73 Fed. Res. Bull. 473, 496 (1987), *aff'd sub nom.* Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 839 F.2d 47, 62 (2d Cir. 1988), municipal revenue bonds, see *Securities Indus. Ass'n*, 839 F.2d at 61, and corporate securities, see J.P. Morgan, 75 Fed. Res. Bull. 192, 195 (1989). Recently, the Federal Reserve Board has loosened the restrictions between banks and their securities affiliates within the holding company structure. See Review of Restrictions on Director, Officer, and Employee Interlocks, Cross-Marketing Activities and Purchase and Sale of Financial Assets Between a Section 20 Subsidiary and an Affiliated Bank or Thrift, 61 Fed. Reg. 57,679 *passim* (1996) (easing or eliminating (1) the prohibition on personnel interlocks between a bank and a securities affiliate of a bank holding company; (2) the restrictions on joint marketing activities between a bank and a securities affiliate; and (3) the restrictions on the purchase and sale of financial assets between a bank and a securities affiliate); and Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 68,750, 68,751 (1996) (increasing from 10% to 25% the amount of total revenue that a nonbank subsidiary of a bank holding company may derive from underwriting and dealing in securities that the bank is prohibited from dealing in). In addition, the Federal Reserve has completely overhauled Regulation Y, the regulation that covers bank holding companies, with an eye toward loosening existing restrictions and adding new activities to the list of those approved as being "closely related to banking." See generally

More significantly, however, bank holding companies will continue to be an important part of the financial services industry because the law says they will. Despite changes in the financial services marketplace that may affect the relative attractiveness of the traditional bank holding company form, the federal banking regulatory scheme regulates any organization that controls a "bank"¹¹ as a "bank holding company"¹² under the Bank Holding Company Act.¹³ Even if Congress repeals Glass-Steagall, it is likely that the old scheme of regulation as it relates to holding company liability for bank failure will continue essentially unchanged.¹⁴ Given the continuing application of bank holding company regulation, clarification of the legal consequences of bank failure for the parent company ought to be a high priority concern for policymakers.

At present, the extent of holding company liability for bank failure is a complicated and confusing mess. Over the years, federal banking regulators have devised a host of legal techniques designed to impose liability on bank holding companies in the event of bank failure.¹⁵ In the emerging financial services marketplace these holding company obligations could indirectly affect nonbanking affiliates within the holding company structure and thereby reduce significantly the benefits of the broad changes that are currently sweeping the in-

Melanie L. Fein, *Fed's Proposed Overhaul of Regulation Y Goes Far, But Could Be Bolder*, BANKING POL'Y REP., Oct. 21, 1996, at 4 (describing the proposed changes to Regulation Y). The Fed's initiative seems to be influencing the expansion plans of players in the banking industry. See Mahua Dutta, *With Rules Eased, Banks Flock to Securities Underwriting*, AM. BANKER, Aug. 18, 1997, at 1, 1 (noting the acquisition of securities firms by large banks and the strategic changes in regional banks' plans).

11. As defined by the Bank Holding Company Act, a "bank" is a financial institution "which [i] accepts demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others on demand; and [ii] is engaged in the business of making commercial loans." 12 U.S.C. § 1841(c)(1)(B).

12. As defined by statute, a bank holding company is any company that has control over a bank or over a company that has control of a bank. See § 1841(a)(1). Typically, although not always, bank holding companies are corporations. But see § 1841(b) (defining bank holding company to mean any "corporation, partnership, business trust, association, or similar organization").

13. See §§ 1841-1850.

14. For example, none of the banking law proposals presented to the 105th Congress called for the wholesale repeal of the Bank Holding Company Act (BHCA), although all would have changed the terminology of the BHCA to refer to "Financial Services Holding Companies" instead of bank holding companies. See Financial Services Competitiveness Act of 1997, H.R. 10, 105th Cong. §§ 128, 129 (1997), Depository Institution Affiliation and Thrift Charter Conversion Act, H.R. 268, 105th Cong. Title II (1997), and Depository Institution Affiliation Act, H.R. 669 & S. 298, 105th Cong. § 102 (1997).

15. These regulatory mechanisms include, among other things, the so-called source of strength doctrine, see 12 C.F.R. § 225.4(a) (1998), cross-guarantee provisions, see 12 U.S.C.A. § 1815(e) (West 1989 & Supp. 1998), capital restoration plans, see 12 U.S.C. § 1831o(e)(2)(C)(ii), regulatory agreements, the elaboration of a general fiduciary duty to regulators, equitable subordination, preferences, and fraudulent conveyances. See Eric J. Gouvin, *Shareholder Enforced Market Discipline: How Much Is Too Much?*, 16 ANN. REV. BANKING L. 311, 333-45 (1997) (describing the various regulatory methods in light of a pervasive scheme to impose liability on holding companies).

dustry. The significance of this potential liability is even greater when one takes into account the possibility that nonfinancial commercial firms may eventually be permitted to own banks.¹⁶

The liability-imposing devices available to the banking regulators, therefore, make a difference in how attractive bank ownership will be. A broad ranging liability regime that puts all of the holding company's assets at stake in the event of bank failure will increase the cost of owning a bank relative to other financial intermediaries and therefore make bank ownership less attractive. On the other hand, a regime that limits the holding company's liability to the amount invested in the bank will make bank ownership relatively more attractive but could result in some costs of bank failure being shifted away from the shareholders onto other parties. Before looking at potential solutions to this problem, this article examines the devices currently available to regulators for shifting the cost of bank failure.

The most powerful tool currently available to banking regulators for indirectly shifting the costs of bank failure to holding companies is the cross-guarantee device created by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA).¹⁷ The cross guarantee provisions allow the receiver of a failed bank to make claims against the sister banks of the failed institution for the loss that the receiver incurs or anticipates that it will incur in disposing of or assisting the failed institution.¹⁸ Although the cross guarantee is a powerful tool, with interstate branching now in effect, fewer and fewer holding companies will own more than one bank subsidiary,¹⁹ thereby

16. This position has been advocated seriously in the current round of proposed banking reform legislation. See Bill McConnell, *Capital Briefs: Treasury Hears Case for Broader Bank Ownership*, AM. BANKER, Feb. 4, 1997, at 2, 2. To some extent, the existence of so-called unitary thrifts has already permitted commercial firms like General Electric and General Motors to operate huge financial businesses within their existing corporate structures. See Steve Cocheo, *Special Briefing: The Banking-Commerce Debate*, A.B.A. BANKING J., July 1997, at 7, 8 (giving an overview of the history and current status of the intermingling of banking and commerce). In light of the fact that Congress has been discussing seriously the idea of eliminating the thrift charter and converting all thrifts into bank charters, a number of financial services providers are rushing to obtain thrift charters in the hope that they will be grandfathered if and when the conversion occurs. See Stephen E. Frank, *Brokers Insurers Queue Up for Thrift Charters*, WALL ST. J., Sept. 24, 1997, at C1. This tactic seems to be especially popular with insurers that desire to enter the banking business. See Steve Cocheo, *What's at Stake with Unitary Thrifts*, A.B.A. BANKING J., Oct. 1997, at 74, 74 (noting that State Farm Insurance Co., Travelers Group, Principal Financial Group, and TransAmerica Corp. have all sought thrift charters). On a limited basis, the state of Utah has already permitted this crossover by allowing nonfinancial firms to acquire Utah industrial banks, which offer deposits insured by the FDIC. See Bill McConnell, *Utah to End Freeze on Charters for Industrial Loan Companies*, AM. BANKER, Apr. 3, 1997, at 3, 3.

17. See Pub. L. No. 101-73, 103 Stat. 183 (1989) (codified in scattered sections of 12 U.S.C. and 27 U.S.C.). The cross-guarantee provisions are codified at 12 U.S.C.A. § 1815(e) (West 1989 & Supp. 1998).

18. See 12 U.S.C.A. § 1815(e).

19. Many large banking firms have decided to consolidate all of their bank charters into one institution, thereby in essence becoming single bank holding companies, or alternatively, shedding the holding company structure altogether to operate as a bank with subsidiaries. See Chase, *supra* note 8, at 4. For example, Minneapolis-based First Bank System, Inc., will combine

rendering the cross-guarantee provisions less effective as a means of shifting the costs of resolving a failed bank. If the cross-guarantee device becomes ineffectual by the implementation of the interstate banking law, bank regulators will in all likelihood look for other ways to protect the deposit insurance fund. The Federal Reserve Board's "source of strength" doctrine may have a new day in the sun.

Under the source of strength doctrine, bank holding companies are required to assist bank subsidiaries in difficult financial times by providing financial assistance to them.²⁰ Although the validity of the source of strength is an open question,²¹ the Federal Reserve Board continues to employ the source of strength idea in its decisions.²² A return to the source of strength doctrine could mean that bank holding companies and, indirectly, their affiliates will essentially become unlimitedly liable for the losses that may occur when an insured bank fails.

The current regulatory scheme goes too far in imposing liability on bank holding companies for bank failure, resulting in negative consequences.²³ I believe the move toward increased liability for bank holding companies is misplaced and should be reassessed to give more respect to the separate legal existence of well-capitalized banks and the holding companies that own them. My conclusions stem from the realization that the trend toward increased holding company liability has not been informed by a consistent and coherent theory. Although federal banking regulation embraces the notion that a holding company should in some circumstances be liable for the failure of its banking subsidiary, the regulatory scheme does not justify that outcome with a rigorous policy rationale capable of providing guidance on the questions of when such liability is appropriate or what the appropriate extent of the liability should be.

Several commentators have offered proposals for rethinking the current scheme of bank holding company liability. Professor Howell Jackson has undertaken the most exhaustive analysis and has concluded that the myriad regulatory devices presently available should be scrapped and replaced by a scheme of enhanced holding company obligations that would apply to all financial holding companies (not

most of its nine banks into one charter. *See id.* KeyCorp, headquartered in Cleveland, will merge its 12 bank subsidiaries into one. *See id.* Other banks taking advantage of consolidation include Wells Fargo & Co., BankAmerica Corp., and First Union Corp. of Charlotte. *See id.*

20. *See* Policy Statement; Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Banks, 52 Fed. Reg. 15,707, 15,707 (1987).

21. For a brief discussion of the evolution of the source of strength doctrine and its current status, see Leonard Bierman & Donald R. Fraser, *The "Source of Strength" Doctrine: Formulating the Future of America's Financial Markets*, 12 ANN. REV. BANKING L. 269, 269 (1993); Gouvin, *supra* note 15, at 333-36.

22. *See, e.g.,* Deutsche Bank AG, 79 Fed. Res. Bull. 133, 137 (1993); Banc One Corp., 78 Fed. Res. Bull. 159, 161 (1992).

23. *See* Gouvin, *supra* note 15, at 345-54.

just bank holding companies) and would be limited to some ascertainable amount, such as five percent of the subsidiary's liabilities or existing capital requirements.²⁴ Professor Jackson's proposals can be justified by one of the traditional policy rationales for holding company liability—the belief that the present regulatory scheme has deteriorated to the point where there must be more incentive on the part of the equityholders in the bank to pay close attention to the level of risk being undertaken by bank managers.²⁵ I call that justification the “market discipline hypothesis.” I have argued elsewhere that the market discipline justification for holding company liability is ineffectual after a certain point,²⁶ and this article argues that Professor Jackson's approach, resting as it does on a faulty justification, falls short of the mark.²⁷

Professor Jackson is the only writer on the topic of holding company obligations who has taken seriously the task of providing a legitimate and rigorous justification for the policy. Others who have written on the topic of holding company liability justify their positions implicitly and without careful scrutiny of the regulatory aims to be achieved. For example, Professor Cassandra Jones Havard has advanced a proposal that would permit regulators to combine banking affiliates in a holding company family into one large bank to satisfy the obligations of a failed banking unit.²⁸ She does not address the larger question of why the law should not respect the bank as a legal entity. Similarly, Professor Lissa Lamkin Broome has proposed an essentially open-ended enterprise liability approach to holding company liability.²⁹ She does not address the question of why the liability should extend beyond the bank itself either. Finally, Professors Jonathan Macey and Geoffrey Miller have suggested that the banking system would do well to return to the idea of double liability for shareholders of failed banks.³⁰ Their approach, like Professor Jackson's, is based on the market discipline idea, but they do not address the concerns raised by this

24. See Howell E. Jackson, *The Expanding Obligations of Financial Holding Companies*, 107 HARV. L. REV. 509, 616 (1994).

25. See *id.* at 513.

26. See Gouvin, *supra* note 15, at 311.

27. See *infra* notes 283-96 and accompanying text.

28. See Cassandra Jones Havard, *Back to the Parent: Holding Company Liability for Subsidiary Banks—A Discussion of the Net Worth Maintenance Agreement, the Source of Strength Doctrine, and the Prompt Corrective Action Provision*, 16 CARDOZO L. REV. 2353, 2358 (1995) (criticizing the source of strength doctrine, regulatory agreements, and the prompt corrective action provisions and suggesting the use of substantive consolidation of bank subsidiaries to shore up a failing bank).

29. See Lissa L. Broome, *Redistributing Bank Insolvency Risks: Challenges to Limited Liability in the Bank Holding Company Structure*, 26 U.C. DAVIS L. REV. 935, 967-1004 (1993) (reviewing the range of enhanced holding company obligations and concluding that the regulatory scheme would work better if the liability of holding companies were more open ended).

30. See Jonathan R. Macey & Geoffrey P. Miller, *Double Liability of Bank Shareholders: History and Implications*, 27 WAKE FOREST L. REV. 31, 33 (1992) (describing the benefits of a double liability system).

article about the appropriateness of that purported justification for bank holding company obligations.

This article remedies the shortcomings of previous approaches to the subject by developing a defensible theory of when it may be appropriate to impose liability on bank holding companies when a bank subsidiary fails. It articulates a new justification for imposing liability on bank holding companies based on the idea that the central issue in banking regulation is the tendency of bank managers to do the bidding of shareholders to the exclusion of other constituencies to whom they may owe a duty, such as depositors, the deposit insurance fund, or even the bank itself as a legal entity.³¹ It argues that the most expeditious way to resolve the conflict between bank shareholders and other bank claimants in the holding company structure is through the application of agency-like principles.³² In short, the quasi-agency approach resolves the conflict problem of subsidiary bank managers by recognizing that the directors of subsidiaries are in some sense the agents of the parent-shareholder. As such, the law should recognize that the directors owe a strong duty to the parent and that the parent duty is likely to override any other duty that the directors may theoretically owe to nonshareholders. In the quasi-agency approach suggested here, the subsidiary directors would be relieved of this conflict by impressing on them a duty to act solely in the shareholder's best interests and then imposing directly on the holding company the responsibility for any duties that the bank subsidiary's directors may owe to nonshareholders. The transfer of these duties can be justified on the theory that the bank directors are essentially agents for the corporate parent. Under the quasi-agency approach, the holding company should be liable only to the extent that the directors of its properly capitalized bank failed to discharge duties to nonshareholder constituents (including any duty to the bank itself as a separate legal entity), and the extent of the liability so incurred should be limited to the harm caused by the failure to discharge the duty.

By imposing the duties to nonshareholder constituencies directly on the holding company the quasi-agency approach frees the bank directors from an otherwise untenable situation where traditional corporate law would charge them with a duty to the corporation generally and the shareholders specifically, but in which their allegiance almost assuredly would be solely with the shareholder's interests.³³ At the same time, the quasi-agency approach gives appropriate

31. This dilemma is what Professor Lawrence Mitchell calls a "horizontal conflict." See Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 603-07 (1992) (describing the idea of horizontal conflicts).

32. This is an extension of an idea first developed in the subsidiary director context. For a more complete description, see Eric J. Gouvin, *Resolving the Subsidiary Director's Dilemma*, 47 HASTINGS L.J. 287 *passim* (1996) (developing the idea of horizontal conflicts from the point of view of directors of subsidiaries).

33. See *id.* at 302-07; Mitchell, *supra* note 31, at 605-07.

respect to the legal entities involved and limits holding company liability to matters where a constituent's interests were not addressed properly because of the hovering presence of the parent holding company.

Part II of the article examines the policy justifications that have been offered in the past for imposing the costs of bank failure on holding companies.³⁴ Those justifications include (1) the idea that banks are "special" and must be protected from failure with extraordinary provisions to safeguard the banking system;³⁵ (2) the "cost defraying" hypothesis whereby enhanced holding company obligations are in some sense a recompense for the generous subsidy provided by banking regulation;³⁶ (3) the "hungry wolf" hypothesis, which casts the holding company as exploiter of its subsidiaries and uses enhanced obligations to even the balance;³⁷ (4) the market discipline hypothesis, which posits that the holding company must have sufficient incentives to monitor the risk taking of bank management;³⁸ (5) the enterprise liability rationale, which seeks to impose costs on the holding company on the theory that the parent and subsidiary corporations are in fact one economic unit;³⁹ and (6) the political explanation, which sees holding company obligations as nothing but wealth transfers from one rent-seeking group to another.⁴⁰ After close examination, part II concludes that none of these justifications provides a compelling reason for imposing broad liability on bank holding companies.

Part III proceeds to rethink the policy justification for imposing liability on bank holding companies by examining the outside limits of such liability.⁴¹ It then develops an alternative justification for imposing some costs of bank failure on the bank holding company based on the quasi-agency idea discussed above. Part IV examines proposals made by other commentators regarding the appropriate limits of enhanced holding company obligations.⁴² Because these approaches rely on the traditional regulatory justifications for holding company liability, however, part IV finds these approaches unsatisfactory. Part V concludes that the horizontal conflict justification is the most defensible policy rationale for enhanced holding company obligations, and that the quasi-agency approach to holding company liability is the most appropriate method of calibrating the amount of liability imposed on the holding company.⁴³

34. See *infra* notes 44-145 and accompanying text.

35. See *infra* notes 51-62 and accompanying text.

36. See *infra* notes 63-82 and accompanying text.

37. See *infra* notes 83-90 and accompanying text.

38. See *infra* notes 91-115 and accompanying text.

39. See *infra* notes 116-29 and accompanying text.

40. See *infra* notes 130-45 and accompanying text.

41. See *infra* notes 146-281 and accompanying text.

42. See *infra* notes 282-334 and accompanying text.

43. See *infra* Part V.

II. JUSTIFICATIONS FOR HEIGHTENED HOLDING COMPANY LIABILITY

A significant problem in addressing the balance of liability between bank holding companies and their bank subsidiaries is that the current regulatory scheme seems to have evolved without the benefit of a guiding theoretical justification. One may examine the existing methods of imposing liability on bank holding companies and deduce from them a theory, but the theory is derivative, not organic. The lack of a guiding principle is hardly surprising because the regulatory response has displayed a classic "incrementalist" development—driven more by a pragmatic imperative to "muddle through" the crisis in front of it than to establish a theoretically coherent and consistent approach to the problem.⁴⁴ Rather than being guided by a grand plan that envisions a particular goal for the banking industry and provides a regulatory scheme calculated to bring it closer to that goal, the present approach to holding company liability instead appears almost entirely remedial and reactive.

Perhaps one of the reasons why there is no grand plan for bank holding company liability is that there has been no thorough articulation of what regulatory goals are advanced through the imposition of that liability. Under ordinary principles of corporate jurisprudence, separate legal entities, even parent and subsidiary, should ordinarily be respected. The disregard of corporate entities requires a compelling justification.⁴⁵ Although the banking regulatory scheme does not need to rest on a rationale sufficient to justify "piercing the corporate veil," it ought to nevertheless rest on a rigorous policy rationale. The lack of a theoretical approach to holding company liability makes the exercise of determining what holding company liabilities *should* be quite difficult.

Banking policy needs to be informed by a sophisticated theory so that policymakers can construct a model of how the world works and make educated decisions about how a particular change in public policy might affect the behavior that they are trying to regulate.⁴⁶ A so-

44. See Charles E. Lindblom, *The Science of "Muddling Through"*, 19 PUB. ADMIN. REV. 79, 80 (1959).

45. Generally courts will disregard the corporate entity only in "rare particular situations to prevent gross inequity." *Evans v. Multicon Constr. Corp.*, 574 N.E.2d 395, 398 (Mass. App. Ct. 1991). In general, the injustice or unfairness complained of must amount to something more than merely stating that the corporation owes the plaintiff money. See *Sea-Land Servs., Inc. v. Pepper Source*, 941 F.2d 519, 522-23 (7th Cir. 1991).

46. The importance of a sophisticated model in the legislative problem-solving methodology is discussed at length in Eric J. Gouvin, *Truth in Savings and the Failure of Legislative Methodology*, 62 U. CIN. L. REV. 1281, 1334-38 (1994) (describing how the failure to construct a sophisticated model of the consumer financial services market has contributed to the adoption of ineffectual legislation); see also Robert B. Seidman, *Justifying Legislation: A Pragmatic, Institutional Approach to the Memorandum of Law, Legislative Theory, and Practical Reason*, 29 HARV. J. ON LEGIS. 1, 32 (1992) (discussing the philosophical beliefs to which legislative drafters must subscribe in order to be effective).

phisticated theory allows regulators to cease merely muddling through and instead to make plans based on a comprehensive, rational model of regulation.⁴⁷ A sophisticated theory also helps policymakers determine if they were successful in meeting the problem that confronted them and whether modifications to the regulatory approach are needed to fine tune the legislative-regulatory response.⁴⁸ Finally, and perhaps most importantly, a theory is needed because in the government's system of checks and balances, acts of the regulatory and legislative arms of government must be justified in acceptable public policy terms.⁴⁹ Actions of regulators and legislators that cannot be so justified are considered illegitimate.⁵⁰

In trying to make sense of the regulatory hodgepodge that constitutes enhanced bank holding company liabilities, several possible justifications have been advanced, including the idea that banks are special; that holding company obligations are a means to replenish the deposit funds; that the obligations are needed to prevent holding companies from exploiting their bank subsidiaries; that the obligations create incentives for holding companies to monitor bank management more closely; that the bank and the bank holding company constitute one economic enterprise and therefore should be treated as such under the law; and, finally, that such regulation can be explained only in political terms. Each of these justifications is discussed below. In my view, none of these offered justifications are compelling enough to warrant the extensive holding company liability the law has imposed.

A. *Specialness*

One way to view the increased obligations of bank holding companies is as a reaction to the idea that banks are in some way "special" so that they should not be allowed to fail.⁵¹ The proponents⁵² of the

47. See Colin S. Diver, *Policymaking Paradigms in Administrative Law*, 95 HARV. L. REV. 393 *passim* (1981) (discussing the comprehensive rationality approach to regulation and contrasting it with the incrementalist approach).

48. To the extent postenactment review of statutes is part of our regulatory landscape, the reviewing body needs some standard against which to measure the statute's effectiveness. See generally Gouvin, *supra* note 46, at 1364-70 (providing a general overview of common postenactment review devices).

49. See *id.* at 1324-25 (noting that legislative enactments must be justified in terms the public will accept as being for the common good).

50. See Cass R. Sunstein, *Interest Groups in American Public Law*, 38 STAN. L. REV. 29, 78 (1985) ("Requiring justifications does not, to be sure, guarantee 'reasoned analysis' on the part of the legislature. . . . But requiring justifications does provide an important prophylactic function.").

51. Probably the clearest expression of the idea that banks are "special" is the so-called too big to fail doctrine. Under that policy, the federal deposit insurance funds made whole all of the depositors of key banks, regardless of whether they were fully covered by deposit insurance, on the theory that to allow the affected bank to fail would have caused major systemic disruption. The too big to fail doctrine may have been eradicated by a provision in the Federal Deposit Insurance Corporation Improvement Act, 12 U.S.C. § 1823(c)(4) (1994), which seeks to limit the insurance protection of large depositors. But proclaiming the demise of the problem may be premature. While § 1823(c)(4) ostensibly eliminates the too big to fail doctrine by strengthening

specialness position have argued that banks are unique players in the economy and deserve special treatment under the law because they possess three key characteristics: (1) they offer transaction accounts; (2) they serve as a backup source of liquidity for other financial institutions; and (3) they serve as the transmission belt for monetary policy.⁵³ The idea of specialness has been attacked on the grounds that the purportedly "special" characteristics are no longer unique to banks; therefore, there is nothing special about banks providing these services.⁵⁴

Another basis for the purported specialness of banks is the observation that the major source of funding for banks comes from the general public and that the depositors need to be protected from bank insolvency.⁵⁵ Perhaps in the days when banks were the primary recipients of household financial assets this rationale may have held some validity, but today there are many other options for the investment of excess household assets, and banks no longer hold the dominant posi-

the requirement of "least cost resolution" on the FDIC's actions, it should be noted that § 1823(c)(4) coexists with the statutory authority of the FDIC to make payments in excess of the insurance coverage amounts if necessary to protect the local economy where the bank failure occurred. See § 1823(c)(4)(G) (1994). How these two provisions will work together in the future remains to be seen.

52. The specialness argument was most clearly articulated by Paul Volcker and Gerald Corrigan in the early to mid 1980s. See Statement Before the Subcomm. on Commerce, Consumer and Monetary Affairs of the Committee on Government Operations, U.S. House of Representatives, June 11, 1986, *reprinted in* 72 Fed. Res. Bull. 541, 542-44 (1986); Paul A. Volcker, Statement Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Sept. 13, 1983, *reprinted in* 69 Fed. Res. Bull. 757, 758-59 (1983); E. Gerald Corrigan, *Are Banks Special?*, FEDERAL RESERVE BANK OF MINNEAPOLIS 1982 ANNUAL REPORT (1982), *in* JONATHAN R. MACEY & GEOFFREY P. MILLER, *BANKING LAW AND REGULATION* 75, 76-79 (2d ed. 1997). For a general discussion and critique of the specialness of banks, see Anthony Saunders, *Bank Holding Companies: Structure, Performance and Reform*, *in* RESTRUCTURING BANKING AND FINANCIAL SERVICES IN AMERICA 156, 157-63 (William S. Haraf & Rose Marie Kushmeider eds., 1988) [hereinafter RESTRUCTURING].

53. See Corrigan, *supra* note 52, at 76.

54. See Richard C. Aspinwall, *On the "Specialness" of Banking*, ISSUES BANK REG., Autumn 1983, at 16, 17. For example, many nonbanks provide transaction accounts which are essentially identical to traditional bank checking accounts. See Jonathan R. Macey & Geoffrey P. Miller, *Nondeposit Deposits and the Future of Bank Regulation*, 91 MICH. L. REV. 237, 237 (1992); David M. Eaton, Comment, *The Commercial Banking-Related Activities of Investment Banks and Other Nonbanks*, 44 EMORY L.J. 1187, 1200-14 (1995). Similarly, banks are no longer the only mechanism for providing liquidity, as technology has made it possible for borrowers to access the credits markets without using banks as intermediaries. See Jonathan R. Macey & Geoffrey P. Miller, *Deposit Insurance, the Implicit Regulatory Contract, and the Mismatch in the Term Structure of Banks' Assets and Liabilities*, 12 YALE J. ON REG. 1, 9 (1995). Finally, banks' role in the implementation of monetary policy is clearly not as important as it may have once seemed. The Federal Reserve carries out its monetary policy goals primarily through the mechanism of open market operations. These purchases and sales of government securities are executed with the cooperation of many players—not just banks, but securities dealers and investors. See Aspinwall, *supra* at 19, 20.

55. See Robert Charles Clark, *The Soundness of Financial Intermediaries*, 86 YALE L.J. 1, 11 (1976); see also Clark, *supra* note 1, at 814-15 (1979) ("The major reason for the enormous amount of special regulation of financial intermediaries, as opposed to nonfinancial business corporations, is to insure their soundness, in order that their public suppliers of capital may be protected against the risk of the intermediaries' financial failure.").

tion.⁵⁶ Given changes in the financial services marketplace, it is hard to make a special case for preventing bank failure as a way to protect the unsophisticated general public unless that rationale also extends to the companies that control mutual funds, securities brokers, and insurance companies. Concern for the "little guy" seems even more out of place as a rationale for preventing bank failure in light of the fact that deposit insurance protects the vast majority of depositors. In the end, although some stalwart supporters of specialness remain, the specialness debate is largely over, and the opponents of specialness won.⁵⁷

Because the Federal Reserve System was the home of specialness's strongest supporters, and because the Federal Reserve regulates bank holding companies, the legacy of specialness lives on. The biggest concern flowing from the idea of specialness was the fear that bank failures could degenerate into banking panics that could topple the entire banking system.⁵⁸ In bank runs, some depositors seek to withdraw their funds not because they have a need for liquidity but rather because they fear that the bank will become insolvent and that they will lose their deposit altogether.⁵⁹ By making the bank holding company serve as a "source of strength," or through other regulatory devices for extracting financial resources from holding companies, the reasoning goes, the law may create an impression of stability in the bank that may counteract the loss of public confidence in a banking crisis. In this way, enhanced holding company obligations may be seen as a strategy to deter bank failure to prevent potentially catastrophic bank runs. By imposing the costs of bank failure on holding companies, the regulatory scheme creates great incentives for the holding companies to keep their banking affiliates afloat or to sell the operation instead of letting the bank go out of business the way a nonbanking commercial firm would. Under this justification for holding company obligations, the costs of bank failure should be shifted to the holding company to the maximum extent possible to prevent bank failure, with the goal of eliminating bank failure, if possible.

56. Other industries competing for household funds include the mutual fund, securities, pension, and insurance industries. Over the past 20 years, banks' share of U.S. financial assets has fallen from 66% to less than 30%. See William S. Haraf, *Emerging Issues in Financial Markets*, REGULATION, Winter 1994, at 12. Some have suggested that banks as they currently exist are actually obsolete. See Jonathan R. Macey & Geoffrey P. Miller, *Bank Failure: The Politicization of a Social Problem*, 45 STAN. L. REV. 289, 290 (1992) ("U.S. banks . . . offer an antiquated, obsolete package of goods and services to consumers who have an ever-increasing array of superior, low-cost substitutes from which to choose.").

57. See Edward E. Furash, *Banks Are Obsolete—And Who Cares*, 1 N.C. BANKING INST. 1 (1997) (articulating comments from industry participant who clearly thought that banks once were special but now conceding defeat with a bit of longing for the good old days).

58. See Anna J. Schwartz, *Financial Stability and the Federal Safety Net*, in RESTRUCTURING, *supra* note 52, at 34, 39 ("The main reason for concern about widespread bank failures is that they may degenerate into banking panics that produce a drastic decline of the money stock with disastrous effects on economic activity.").

59. See Saunders, *supra* note 52, at 158 (explaining the dynamics of a bank run).

On closer examination of the available evidence, however, the fear of a bank failure expanding into the potential failure of the entire banking system appears unjustified.⁶⁰ Such a catastrophic domino effect is in reality a very rare event.⁶¹ It is much more likely that a bank run would result in the redepositing of funds from weak banks into strong banks.⁶² Therefore, if the specialness of banks is the justification for increased bank holding company liability, that justification is subject to a strong empirical challenge and, thus, does not provide a solid footing for the regulatory scheme. Conversely, if banks are not special, there needs to be some explanation for why the scheme of parent liability in the banking industry departs from the traditional scheme of respecting separate legal entities.

B. *The Cost-Defraying Hypothesis*

One way to explain why the banking regulators have developed extensive holding company liability rules is what Professor Howell Jackson has called the "cost-defraying hypothesis"⁶³ or, to put it more colloquially, the "deep pocket" theory. In short, the deposit insurance funds are not inexhaustible, and the regulatory scheme has developed ways to recapitalize those depleted funds from sources other than the taxpaying public.⁶⁴ Such a justification could be grounded on the reasoning that because holding companies benefit from the deposit insurance that covers their banking subsidiaries, they should pay the price as well. A quote from the Senate report on FIRREA's cross-guarantee provisions illustrates the cost-defraying idea quite clearly: "A parent company that has benefitted from Federal Deposit Insurance protections of its depository institution subsidiary should absorb losses incurred by that institution before they are passed on to the taxpayer."⁶⁵

60. See *id.* at 162 ("One problem [with the specialness idea] has been the tendency to exaggerate the social costs of bank failures by loosely extrapolating the effects of an individual bank failure into a potential failure of the whole system."); Daniel R. Fischel et al., *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 310-11 (1987) (discussing, and dismissing, the idea that bank failures are contagious). The economic models that predict dire consequences from bank failure are too oversimplified to justify larger systemic policy decisions. See Saunders, *supra* note 52, at 158.

61. See Schwartz, *supra* note 58, at 39-40, 55-56 n.1 (noting that prior to 1930, banking panics were uncommon and providing empirical evidence to support her conclusion).

62. See Saunders, *supra* note 52, at 159 (citing a study that concluded that most runs on individual banks would result in redepositing to sound banks).

63. See Jackson, *supra* note 24, at 559 (describing the cost-defraying explanation).

64. See *id.* But see Alfred J.T. Byrne & Judith Bailey, *FDIC Addresses Three D&O Lawsuit Issues*, A.B.A. BANKING J., Oct. 1992, at 47, 48 (stating that the FDIC officially denies that it sues all deep pockets).

65. See S. REP. NO. 102-167, at 60 (1991).

An underlying premise to this position is the idea that banks receive a subsidy from the federal government.⁶⁶ In the words of Federal Reserve Chairman Alan Greenspan

In this century the Congress has delegated the use of sovereign credit—the power to create money and borrow unlimited funds at the lowest possible rate—to support the banking system. It has done so indirectly as a consequence of deposit insurance, Federal Reserve discount window access, and final riskless settlement of payment system transactions. . . .

. . . .

. . . [As a result of the government's major role in protecting the banking system, banks get an unfair advantage over other financial services providers because banks] determine the level of risk-taking and receive the gains therefrom but do not bear the full costs of that risk. The remainder of the risk is transferred to the government.⁶⁷

Although Greenspan sees the creation of a subsidy to banking as an “undesirable but unavoidable consequence of creating a safety net,”⁶⁸ he believes that the subsidy should be contained within the bank to the extent possible to prevent the transfer of the sovereign credit subsidy for nonbanking purposes, which might result in a “subsidized competitive advantage” to the bank affiliate.⁶⁹ Imposing liabilities on holding companies when subsidized banks fail could be justified as a way for the government to recoup part of the subsidy that the holding company supposedly profited from during the operation of the bank. If this is the basis for holding company liability, one would think that the fair limit of liability should be the value of the subsidy received, although this idea has never been seriously proposed.

While the cost-defraying justification clearly has an attractive political aspect⁷⁰ and is anchored in the intuitively simple connection to covering the costs of the insurance fund, it is subject to criticism on at least three grounds. First, the existence of a “subsidy” from the federal government to the banking system is by no means a universally

66. See David G. Oedel, *Puzzling Banking Law: Its Effects and Purposes*, 67 U. COLO. L. REV. 477, 479 (1996) (“[B]anking law enshrines fundamental economic inefficiencies in banking that are tolerable for banks because of breathtaking anticompetitive protections and financial subsidies—protections and subsidies that are not always apparent to outsiders nor admitted publicly by banking savants.”).

67. Statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, Before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Banking and Financial Services, U.S. House of Representatives, Feb. 13, 1997, *reprinted in* 83 Fed. Res. Bull. 249, 249-50 (1997).

68. See *id.* at 250.

69. See *id.*

70. See Peter P. Swire, *Bank Insolvency Law Now That It Matters Again*, 42 DUKE L.J. 469, 520-29 (1992) (describing a link between the health of the deposit insurance fund and political pressure for cost-defraying rules).

accepted notion.⁷¹ Other regulators have pointed out that while deposit insurance may bestow a subsidy of approximately four to seven basis points, that benefit is more than outweighed by the regulatory costs of obtaining deposit insurance, maintaining capital reserves, undergoing examinations, and complying with safety and soundness regulations.⁷²

Second, if the imposition of liability is a payback for the benefits bestowed by deposit insurance, clearly the holding company is not the only market participant that should be potentially liable. Other beneficiaries of the deposit insurance scheme include borrowers, depositors, and bank employees, yet they are not targeted for additional liability after an insured institution fails.⁷³

Third, the idea that after the fact liability is recompense for the benefit of deposit insurance neatly glosses over the fact that the insured institutions have already paid for the insurance coverage.⁷⁴ Proponents of the cost-defraying hypothesis do not offer a convincing argument for treating deposit insurance differently from other kinds of insurance. Some commentators have noted that federal deposit insurance is meaningfully different from private insurance contracts because private insurers are free to use such contractual devices as deductibles, coinsurance, and risk-related premiums, while the federal deposit insurers traditionally have not been able to avail themselves of those techniques.⁷⁵

This argument is no longer true. The FDIC now has many of the same contractual tools at its disposal that private insurers have.⁷⁶ For example, the deposit insurance program has always used the technique of policy limits, by limiting the coverage for deposit insurance to

71. See Statement of Eugene A. Ludwig, Comptroller of the Currency, Before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Banking and Financial Services, U.S. House of Representatives, Feb. 13, 1997 (visited Aug. 31, 1997) <<http://www.house.gov/banking/21397occ.htm>> (refuting the subsidy hypothesis); Testimony of Ricki Helfer, Chairman, Federal Deposit Insurance Corporation, Before the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises of the Committee on Banking and Financial Services, U.S. House of Representatives, Mar. 5, 1997 (visited Aug. 31, 1997) <<http://www.fdic.gov/publish/speeches/97spchs/sp05mar.html>> (concluding, after rebutting the points made by Chairman Greenspan, "[I]f banks receive a net subsidy from the federal safety net, it is small.").

72. See Statement of Eugene A. Ludwig, *supra* note 71; Testimony of Ricki Helfer, *supra* note 71 (noting that the FDIC estimates the cost to banks of the federal safety net subsidy received at 33 basis points).

73. See Jackson, *supra* note 24, at 561, n.192.

74. See Testimony of Ricki Helfer, *supra* note 71 (noting that the banking industry, not the government, pays the premiums that fund the deposit insurance program, and that recourse to the full faith and credit of the federal government would only apply in the event the deposit insurance fund fails—which it has never done on the banking industry side).

75. See Fischel et al., *supra* note 60, at 314-15.

76. For a general discussion of the pros and cons of this idea, see James R. Barth et al., *Reforming Federal Deposit Insurance: What Can Be Learned from Private Insurance Practices?*, 45 CONSUMER FIN. L.Q. 140 *passim* (1991).

accounts held in a particular right or capacity to \$100,000.⁷⁷ Although Congress has not used control of policy limits as aggressively as possible in controlling deposit insurance costs,⁷⁸ it has used the policy limit rationale to tighten some regulations to lower the likelihood that one customer could have several insured accounts. More recently, the FDIC has enacted risk-based deposit insurance premiums.⁷⁹ Under the current regime, a bank's deposit insurance premiums are now linked to the bank's exposure to interest rate-risk, credit risk, insider abuse, operating risk, and diversification risk.⁸⁰ Similarly, the capital requirements that banks must comply with serve a function similar to the role played by the deductibles in the private sector. Even more explicitly, Congress has experimented with some privatization techniques by authorizing the FDIC to engage in reinsurance of the deposit insurance risk.⁸¹

These techniques taken together, along with the extensive regulatory powers that the FDIC exercises over its insured institutions (far more extensive and invasive than any comparable oversight by private insurance providers), should put the FDIC in a position to run the deposit insurance fund like a private insurance company. Viewed in this light, deposit insurance should be treated like other kinds of insurance, and the relative rights of the insured and the insurer should be informed accordingly.⁸² The cost-defraying rationale does not offer a credible explanation for why deposit insurance should operate differently.

77. See 12 U.S.C. § 1813(m) (1994); see also Deposit Insurance Coverage, 12 C.F.R. § 330.3 (1998). The FDIC may have compromised the value of this mechanism by imprudent invocation of the "too big to fail" doctrine whereby all depositors, insured and uninsured, were promised full return of their funds, but nevertheless, the technique is available and used by the FDIC. Critics could point out that the deposit limits are relatively easy to circumvent, see Gouvin, *supra* note 15, at 321-22, but that does not change the fact that the technique, though imperfect, is nevertheless available to the FDIC in managing the deposit insurance risk.

78. For example, the report from the Treasury Department on modernizing the banking system had suggested reducing the policy limits to \$100,000 per customer per bank so that a given individual would not be able to "double dip" by holding accounts in several rights and capacities at the same institution. See U.S. TREASURY DEP'T, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS 19 (1991). This recommendation was not adopted by Congress in subsequent banking legislation.

79. See § 1817(b)(1)(A).

80. See James Chessen, *How FDIC's Risk-Based Insurance Premiums Work*, A.B.A. BANKERS WKLY., Oct. 6, 1992, at 8.

81. See § 1817(b)(1)(B). For an excellent discussion of the many issues raised by the possible use of the reinsurance market to help spread the risks of deposit insurance, see Anna Kuzmik Walker, *Harnessing the Free Market: Reinsurance Models for FDIC Deposit Insurance Pricing*, 18 HARV. J.L. & PUB. POL'Y 735, 752-75 (1995).

82. By analogy, it would be outrageous for a homeowner who is covered by fire insurance to be held personally liable for the damage done to an insured dwelling that burns to the ground except in the special case where the homeowner set the fire or arranged for it to be set. Her rates may go up in the future, and she may be classified as a "bad risk," but she is not liable for the insured event.

C. *The Hungry Wolf Hypothesis*

A third justification for the extensive parental liability provisions is what Professor Jackson calls the "hungry wolf" hypothesis, which operates on the presumption that holding companies, left to their own devices, would prey upon and devour their regulated subsidiaries, therefore requiring close supervision.⁸³ The hungry wolf idea focuses on the potential exploitation of the bank by the holding company for self-dealing or other conflict of interest transactions. Much of the fear that gives rise to the hungry wolf hypothesis is the legacy of the Senate hearings conducted in 1933 and 1934 to examine the development of the Great Depression. Upon closer examination, many of the horror stories that sensationalized those hearings do not hold up,⁸⁴ yet the hearings continue to have an influence on banking policy.⁸⁵

The potential conflicts of interest that tempt bank holding companies to exploit their subsidiaries and their customers were termed "subtle hazards" in *Investment Company Institute v. Camp*.⁸⁶ Possible subtle hazards that have been identified in the scholarly treatment of the subject include (1) the potential for biased advice to clients designed to benefit the holding company's nonbanking operations; (2) uneconomical transfers, such as bank loans to troubled holding company subsidiaries; (3) bank trust department securities transactions designed to bolster the offerings of an investment bank affiliate; (4) predatory practices and collusion between the bank and other affiliates designed to injure other competitors of the affiliates; (5) and the possibility of tying arrangements by which bank services and products would only be available in conjunction with the purchase of affiliates' products and services, perhaps at an above-market price.⁸⁷

83. See Jackson, *supra* note 24, at 564-68.

84. See GEORGE J. BENSTON, *THE SEPARATION OF COMMERCIAL AND INVESTMENT BANKING: THE GLASS-STEAGALL ACT REVISITED AND RECONSIDERED* 4-5 (1990) (stating that after tracking down all the claims made by Senate staffer Ferdinand Pecora in his 1939 book *Wall Street Under Oath*, Benston found that almost none of them are supported by evidence actually presented in the hearings). See generally Randall S. Kroszner & Rajan G. Raghuram, *Is the Glass-Steagall Act Justified? A Study of the U.S. Experience with Universal Banking Before 1933*, 84 AM. ECON. REV. 810 (1994) (analyzing the sale of low-quality securities before and after the separation of commercial banking and investment banking and finding no evidence indicating that the Glass-Steagall Act had any effect on the problem).

85. See, e.g., Board of Governors of the Fed. Reserve Sys. v. Investment Co. Inst., 450 U.S. 46, 61-62 (1981) ("The legislative history reveals that securities firms associated with banks had engaged in perilous underwriting operations, stock speculation, and maintaining a market for the bank's own stock, often with the bank's resources.").

86. 401 U.S. 617 (1971).

87. See Fischel et al., *supra* note 60, at 323-30 (discussing the "subtle hazards" suggested by the *Camp* decision); see also James R. Smoot, *Striking Camp and Moving to Higher Ground: The Hazardous Subtleties of "Subtle Hazards" in Bank Regulation*, 4 GEO. MASON L. REV. 21, 38-40 (1995) (discussing "subtle hazards" in light of the *Camp* decision and the history of the Glass-Steagall Act).

While there may be some anecdotal evidence that bank holding companies take advantage of their subsidiaries,⁸⁸ there is no clear empirical evidence that holding companies in fact exploit their banks to the extent feared by the hungry wolf model.⁸⁹ The “subtle hazards” idea nevertheless continues to have force in the judicial decisions affecting bank holding company activities⁹⁰ and may also cloud the thinking of legislators confronting banking issues. To the extent the justification cannot withstand empirical scrutiny, however, it loses a great deal of persuasive effect.

D. *The Market Discipline Hypothesis*

The imposition of “market discipline” on bank management has also been offered as a justification for enhanced bank holding company obligations.⁹¹ The goal of market discipline is to create financial incentives for holding companies to monitor the managers of their banking subsidiaries and thereby dampen the risk-taking tendencies of the bank. The market discipline mechanism has been devised as a means to fill the gap left by traditional prophylactic regulatory approaches that have fallen short in the goal of tempering bank managers’ appetite for risk.⁹²

The market discipline idea is really a response to the moral hazard problem, that is, the persistent conflict between fixed-claim creditors (especially depositors) and the equityholders (especially bank holding companies).⁹³ Ostensibly, holding companies, as the residual

88. See Kieran J. Fallon, Note, *Source of Strength or Source of Weakness?: A Critique of the “Source-of-Strength” Doctrine in Banking Reform*, 66 N.Y.U. L. REV. 1344, 1383 (1991) (listing several ways in which bank holding companies might take advantage of their banking subsidiaries); see also Gouvin, *supra* note 32, at 289-90 (1996) (noting the many situations in which parent corporations may take advantage of their subsidiaries).

89. See Jackson, *supra* note 24, at 573-76 (reviewing and summarizing various studies concerning the effect of bank holding company ownership on bank performance and finding “there is little evidence supporting, and a considerable amount rebutting, the hungry wolf justification.”). Given the current regulatory “firewalls” in the bank holding company structure, even during the stock market crash of October 1987, insured bank subsidiaries of SEC-regulated securities firms did not make improper advances to their parents, subsidiaries, or affiliates. See Thomas F. Huertas, *Commentary*, in *RESTRUCTURING*, *supra* note 52, at 211, 212. In fact, even back in the free-wheeling 1920s, large commercial banks and their investment bank affiliates fared much better than smaller banks that were only engaged in commercial banking. See BENSTON, *supra* note 84, at 32 (noting that national banks which engaged in both commercial and investment banking had a lower failure rate than those that just engaged in commercial banking).

90. See Smoot, *supra* note 87, at 40-42 (citing a long string of cases that have employed the subtle hazards analysis).

91. See generally Helen A. Garten, *Market Discipline Revisited*, 14 ANN. REV. BANKING L. 187 (1995) (providing an overview of the market discipline debate). Professor Jackson describes a justification for holding company obligations that he labels the “Regulatory Deterioration Hypothesis,” which appears in its essential elements to be very similar to the market discipline justification. See Jackson, *supra* note 24, at 568-72.

92. See Jackson, *supra* note 24, at 570.

93. This conflict is known as the moral hazard problem. See Gouvin, *supra* note 15, at 312-17 (providing a general overview of the moral hazard problem in the banking context).

takers, prefer relatively risky activities and assets (promising higher returns), while creditors prefer less risky activities and assets (providing a more stable return and helping assure repayment of the amounts owed). Because of this conflict, bank managers are constantly tempted to engage in "asset substitution"—that is, to replace low-risk assets with higher-risk assets that promise higher returns.⁹⁴ By engaging in risky activity or substituting risky assets for conservative ones, bank equityholders in effect transfer wealth to themselves from their creditors.⁹⁵ Intuitively, it would appear that the moral hazard temptation would be felt more keenly when the bank has only one shareholder and that shareholder has both the incentive and the ability to exploit the situation.⁹⁶

Of course, the moral hazard problem is not unique to the bank holding company situation.⁹⁷ In general, a moral hazard results whenever one actor or class of actors in a transaction can undertake risky behavior without fear of loss because the loss from the risky activity falls on a different actor or group of actors by contract or other arrangement.⁹⁸ All financial institutions, whether independent or within a bank holding company, closely held or widely held, face the same temptations.⁹⁹ Yet only banks owned by holding companies are burdened with the special shareholder liability enshrined in the banking regulation.

94. See William W. Bratton, Jr., *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92, 112 (describing the idea of asset substitution in the corporate context generally); Patricia A. McCoy, *A Political Economy of the Business Judgment Rule in Banking: Implications for Corporate Law*, 47 CASE W. RES. L. REV. 1, 10-11 (1996) (describing the phenomenon of asset substitution in the banking context).

95. See Fischel et al., *supra* note 60, at 314 (discussing moral hazard and providing an example).

96. See Jackson, *supra* note 24, at 565-66; see also Gouvin, *supra* note 32, at 289-90 (describing the pressure to do the parent company's bidding).

97. In fact, "moral hazard" may be present in any number of situations from products liability and workers' compensation to bankruptcy and health care. The idea of moral hazard is present in any situation where the existence of some kind of insurance or cost shifting is perceived to reduce the incentives to reduce or minimize loss. See Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237, 238-40 (1996) (providing a history of the term "moral hazard" and criticizing its use in the debate over the reform of various government programs on the ground that the conditions necessary to give the concept force in economic theory do not exist in the real world).

98. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 120 (5th ed. 1998). Moral hazards are present in all transactions in which an actor may be shielded from liability by insurance or by limited liability business forms. See Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 103-04 (1985). All corporations entail some moral risk, for example, because the limited liability form always presents opportunities to shift losses from the equityholders to creditors and other claimants. See *id.*

99. Some empirical evidence suggests that stock ownership of thrift institutions in the 1980s resulted in riskier financial institutions than would have been the case if the industry had remained primarily in the mutual form of ownership. See Lawrence R. Cordell et al., *Corporate Ownership and the Thrift Crisis*, 36 J.L. & ECON. 719, 751-54 (1993) (noting that stock chartered thrifts and thrifts that converted from mutual to stock ownership were riskier and incurred higher losses than those that were owned in the mutual form, although conceding that the effects of regulatory missteps make the correlation less compelling).

Within limits, increasing managerial accountability may be a worthy regulatory goal because management weaknesses undoubtedly contributed to the banking and thrift crises of the 1980s and early 1990s.¹⁰⁰ The goal of implementing more stringent management oversight, however, may be easier to state than to execute.¹⁰¹ The market discipline idea relies on the holding companies' vested interest in preventing losses at the holding company level to create incentives for monitoring the risk taking of their bank managers. Heightened oversight of bank management is likely to result in a more conservative bank management, but it remains to be seen whether increased monitoring by holding companies will result in fewer run-of-the-mill lapses of judgment that necessarily plague all human activity.¹⁰² It seems obvious that even without the complicating presence of a moral hazard, a certain number of mistakes will occur just because humans make mistakes, and bank directors are humans.¹⁰³

Even if monitoring management may be a marginally useful approach to reducing the risk of bank failure, when the policy is examined more closely, it fails to supply a compelling justification for

100. The Congressional Budget Office reports that a study by the Office of the Controller of the Currency (OCC) found that so-called management-driven weaknesses played a "significant role" in the decline of 90% of the resolved and problem banks. See CONGRESSIONAL BUDGET OFFICE, U.S. CONGRESS, *THE CHANGING BUSINESS OF BANKING: A STUDY OF FAILED BANKS FROM 1987 TO 1992*, at 19-20 (1994) [hereinafter CBO STUDY]. These management-driven weaknesses include everything from poorly followed loan policies, excessive loan growth, and over-concentration in a particular industry to inadequate compliance systems, poor loan monitoring, and accounting deficiencies. It should be noted, however, that "[t]hese results do not imply that 90 percent of bank losses can be attributed to management problems, nor does it mean that different management could have averted 90 percent of bank failures." *Id.* at 20. The OCC study found that 35% of the banks that failed did so due to "external economic conditions" such as inflation, recession, competition, and interest rate volatility. See *id.*

101. Fixing corporate boards to make them more attentive to nonshareholder interests or at least less enthralled to the controlling shareholder by appointing outside directors, for example, is easier to discuss in the abstract than to implement in actual corporations. See Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 940 (1996) (noting that the available empirical evidence does not conclusively indicate the degree to which outside directors have a meaningful impact on corporate governance but does suggest that independent boards are not a cure-all to problems of management accountability, although they do perform some checking functions).

102. Generally, bank directors will not be liable for simple lapses of judgment. See, e.g., *Muller v. Planter's Bank & Trust*, 275 S.W. 750, 752 (Ark. 1925) (holding that bank directors must exercise good faith and diligence in managing a bank, but are not liable for mere exercise of poor judgment); *Warren v. Robinson*, 70 P. 989, 990 (Utah 1902) (holding that directors will not be responsible for depreciation in value of bank stock when such depreciation results from errors of judgment).

103. At least one knowledgeable observer is skeptical of the conventional wisdom that the moral hazard exacerbated by the presence of deposit insurance really explains the rash of international banking crises witnessed in the 1980s and 1990s. Instead, says former FDIC Chairman L. William Seidman, the problems are more directly linked to flawed lending practices, especially in the real estate sector. See L. William Seidman, *The World Financial System: Lessons Learned and Challenges Ahead*, in 2 FEDERAL DEPOSIT INS. CORP., *HISTORY OF THE EIGHTIES: LESSON FOR THE FUTURE* 55, 58 (1997) ("[I]n looking around the world, the risks were taken without regard to whether the deposit insurance system was comprehensive as in the United States, minimal as in the UK, moderate as in Japan, or essentially non-existent as in New Zealand.").

holding company liability for at least two reasons. First, it amounts to closing the barn door after the horse has escaped. Changes in the regulatory scheme that make it much more difficult for banks to exploit the most pernicious manifestation of the moral hazard problem—using insured brokered deposits to fuel reckless banking practices—should eliminate the most troubling aspect of the problem.¹⁰⁴

Second, the market discipline hypothesis may overstate the role that directors realistically can play in insuring the safety and soundness of the institutions they manage.¹⁰⁵ Generally, corporate directors' decisions are evaluated by the business judgment rule. They are not required by the law to do more than an ordinarily prudent person,¹⁰⁶ in a like position under similar circumstances, would do, acting in good faith, in a manner reasonably believed to be in the best interest of the corporation.¹⁰⁷ Except for some mostly antiquated cases to the contrary,¹⁰⁸ bank directors are not held to a higher standard than corporate directors generally.¹⁰⁹ Of course, the duty of any corporate director is to be vigilant and attentive to the circumstances of the

104. See Gouvin, *supra* note 15, at 314-17 (describing changes in bank regulation designed to thwart troubled banks from using insured deposits to fund risky activities).

105. See *id.* at 345-50; see also John D. Hawke, Jr., *The Limited Role of Directors in Assuring the Soundness of Banks*, 6 ANN. REV. BANKING L. 285, 287 (1987) (arguing that bank directors typically have neither access to information nor the banking skills necessary for the effective prevention of bank failure).

106. One must keep in mind that the "ordinarily prudent person" who serves as a bank director is typically not a banking professional and therefore has limited expertise in second-guessing senior bank management. Small bank directors in particular are likely to be local business people who are "neither . . . expert[s] in banking nor . . . professional manager[s]." Hawke, *supra* note 105, at 286. Even in well-run banks, it is difficult for directors to access and correctly interpret the kinds of information they need to properly run a bank, and even if they could, it is not feasible to expect directors to become involved in operational matters, such as determining the appropriate loan loss reserve or the writing down of loans. See *id.* at 288. The difficulties facing directors are even greater for the "outside" directors, who not only must rely on second-hand information, but also operate under severe time constraints due to pressure from their other nonbank commitments. See Committee on Corporate Laws, *Guidelines for the Unaffiliated Director of the Controlled Corporation*, 44 BUS. LAW. 211, 212-13 (1988) (pointing out that outside directors face "practical difficulties" in fulfilling the review function, especially lack of access to relevant information); Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1481, 1487-88 (1984); Hugh F. Sharber, Comment, *A Realistic Duty of Care for Outside Bank Directors*, 51 TENN. L. REV. 569, 573 (1984).

107. This is the standard imposed by the typical state corporate statute, see MODEL BUS. CORP. ACT § 8.30(a) (1994), and it derives in large part from an influential decision by the U.S. Supreme Court regarding the liabilities of bank directors. See *Briggs v. Spaulding*, 141 U.S. 132, 152 (1891) (noting that bank directors must exercise the degree of care "which ordinarily prudent and diligent men would exercise under similar circumstances," in light of "the restrictions of the statute and the usages of business").

108. See, e.g., *First Nat'l Bank v. Doherty*, 161 S.W. 211, 214 (Ky. 1913) (holding bank directors liable as trustees); *Greenfield Sav. Bank v. Abercrombie*, 97 N.E. 897, 899-900 (Mass. 1912) (treating bank directors as trustees to depositors). Cases like these have been roundly criticized. The modern view is that a special duty of care for bank directors is "unjustified and anachronistic." See PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(a) reporter's note 18, at 161 (Proposed Final Draft Mar. 31, 1992).

109. But see McCoy, *supra* note 94, at 10-12 (arguing that courts have in fact modified the business judgment rule in banking to counteract the problem of asset substitution).

particular corporation and its business,¹¹⁰ and the circumstances of running a banking business may require a great deal of attention and care, but that is not to say that bank directors as bank directors owe a higher duty than, for example, directors of hospitals, securities firms, or automobile manufacturers.

Even with the legal standard of care hanging over their heads, there is a limit to what directors can be expected to do. Their role is to set policy and to oversee the officers, not to engage in a hands-on supervision of operations.¹¹¹ In light of that reality, the directors may be ineffectual in stopping operational problems. For example, if the officers of the bank are committing fraud or even just covering their mistakes, it will be extremely difficult for any monitor to detect, be it the board of directors or the holding company, because the officers can conceal information relatively easily.¹¹² Ironically, as banking policy moves in the direction of making directors and holding companies serve as watchdogs over bank officers, the officers may be even more tempted to conceal necessary information to avoid criticism.¹¹³

To the extent that some degree of market discipline from the equityholders is desirable, the enhanced capital standards governing banks put enough at stake for the equityholders to monitor bank management as well as they can.¹¹⁴ The biggest problem with the current extensive array of holding company obligations is that they are not well calibrated to exact the maximum amount of monitoring without unduly penalizing the holding companies. Beyond the heightened attentiveness that the capital standards create, it seems doubtful that the enhanced holding company obligations can make the monitoring process any more effective or make the role that management plays in maintaining a safe and sound bank any more meaningful. In short, as I have argued elsewhere, everything after the increased capital requirements results in diminishing returns in terms of enhanced monitoring.¹¹⁵

110. See *Francis v. United Jersey Bank*, 432 A.2d 814, 821 (N.J. 1981) (articulating the duty that "the directors must discharge their duties in good faith and act as ordinarily prudent persons would under similar circumstances in like positions").

111. Delaware corporate law seems, however, to be pointing in the direction that directors should have some system of compliance review in place to monitor corporate activities. See *In re Caremark Int'l, Inc.*, 698 A.2d 959, 969-70 (Del. Ch. 1996) (writing a memorandum decision, Chancellor Allen suggested that Delaware law and the dictates of federal sentencing guidelines, among other things, weigh in favor of requiring a corporation to have some form of legal compliance oversight in place). But see *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963) (setting forth the view that directors need not have in place "a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists").

112. See *Hawke*, *supra* note 105, at 287.

113. See *id.*

114. There appears to be a strong connection between capital levels and thrift failure. See *Cordell et al.*, *supra* note 99, at 724-27. "The ability to take on riskier investments at higher leverage ratios directly benefitted stock S&L owners, who could capitalize these benefits directly through appreciation of their stock holdings." *Id.* at 726.

115. See *Gouvin*, *supra* note 15, at 350-53.

E. *The Control/Enterprise Liability Rationale*

Another rationale for imposing subsidiary obligations on the parent would be that in reality the two formally distinct legal entities are a single economic unit and should therefore be regulated as one enterprise. Professor Phillip Blumberg's extensive treatise, *The Law of Corporate Groups*, explores this line of reasoning as it plays out through many different legal techniques and in many different areas of law.¹¹⁶ In the heavily regulated banking industry, for example, Professor Blumberg notes that the statutory scheme relies on the idea of common control as the basis for imposing enterprise principles.¹¹⁷ Why common control in the banking arena is enough to impose enterprise liability whereas common control in, for example, the modern corporate conglomerate is not, if ever, completely explained. Perhaps the reason is that bank holding company liability is politically feasible. After all, enterprise liability, in Professor Blumberg's words, "rest[s] on essentially pragmatic considerations rather than on any transcendental legal concept."¹¹⁸

Viewed through the lens of enterprise liability, the fiction of a separate corporate personality for each subsidiary in a corporate group must give way to the reality of a single economic enterprise. In the real world there is little practical difference between a wholly owned subsidiary and a traditional corporate division; therefore, it seems inappropriate that the legal treatment of one should differ from the other unless the goal of the law is to respect formal legal distinctions above all else.¹¹⁹ Proponents of enterprise liability argue that to

116. See generally PHILLIP I. BLUMBERG, *THE LAW OF CORPORATE GROUPS: PROBLEMS IN THE BANKRUPTCY OR REORGANIZATION OF PARENT AND SUBSIDIARY CORPORATIONS, INCLUDING THE LAW OF CORPORATE GUARANTEES* (1985) [hereinafter BLUMBERG, *BANKRUPTCY*]; PHILLIP I. BLUMBERG, *THE LAW OF CORPORATE GROUPS: PROCEDURAL PROBLEMS IN THE LAW OF PARENT AND SUBSIDIARY CORPORATION* (1983) [hereinafter BLUMBERG, *PROCEDURAL*]; PHILLIP I. BLUMBERG & KURT A. STRASSER, *THE LAW OF CORPORATE GROUPS: PROBLEMS OF PARENT AND SUBSIDIARY CORPORATIONS UNDER STATE STATUTORY LAW* (1995) [hereinafter BLUMBERG & STRASSER, *STATUTORY LAW: STATE*]; PHILLIP I. BLUMBERG, *THE LAW OF CORPORATE GROUPS: PROBLEMS OF PARENT AND SUBSIDIARY CORPORATIONS UNDER STATUTORY LAW OF GENERAL APPLICATION* (1989) [hereinafter BLUMBERG, *STATUTORY LAW: GENERAL*]; PHILLIP I. BLUMBERG & KURT A. STRASSER, *THE LAW OF CORPORATE GROUPS: PROBLEMS OF PARENT AND SUBSIDIARY CORPORATIONS UNDER STATUTORY LAW SPECIFICALLY APPLYING ENTERPRISE PRINCIPLES* (1992) [hereinafter BLUMBERG & STRASSER, *STATUTORY LAW: SPECIFIC*]; PHILLIP I. BLUMBERG, *THE LAW OF CORPORATE GROUPS: TORT, CONTRACT, AND OTHER COMMON LAW PROBLEMS IN THE SUBSTANTIVE LAW OF PARENT AND SUBSIDIARY CORPORATIONS* (1987) [hereinafter BLUMBERG, *SUBSTANTIVE COMMON LAW*].

117. See Phillip I. Blumberg, *The Increasing Recognition of Enterprise Principles in Determining Parent and Subsidiary Corporation Liabilities*, 28 CONN. L. REV. 295, 298 n.6 (1996).

118. *Id.* at 299.

119. See MELVIN A. EISENBERG, *THE STRUCTURE OF THE CORPORATION* 303 (1976). Proponents of enterprise liability would say that not only does the traditional independent entity model of the corporation not reflect the real world, it also presents an obstacle to clear thought on the matter of how corporate groups should be treated under the law. See ELVIN R. LATTY, *SUBSIDIARIES AND AFFILIATED CORPORATIONS* 27 (1936) ("The defects of the intransigent conceptualism which apparently accompanies the entity technique is of itself a source of danger in legal thinking.").

deal effectively with the legal issues of subsidiaries, the law needs to break out of traditional paradigms and embrace the idea of a corporate enterprise that cuts across particular legal entities.¹²⁰

The U.S. Supreme Court adopted an enterprise liability view of bank holding companies over fifty years ago in the case of *Anderson v. Abbott*.¹²¹ The Court faced a conundrum in interpreting a banking statute that imposed an assessment on shareholders of national *banks* but was silent about any assessment on the shareholders of a bank *holding company* that owned a national bank. In a close decision, the Court decided that the assessment provision reached the shareholders of the holding company, reasoning that formal legal distinctions should not prevail over the reality of the situation.¹²² *Anderson* aside, however, judicial decisions invoking enterprise liability principles are comparatively rare. Nevertheless, the statutory scheme that regulates bank holding companies is informed by the enterprise liability idea.

In the bank holding company context, the enterprise idea does not hold up as well as its supporters might hope. Banks that are part of a bank holding company must meet the same requirements that all banks do—capital requirements and regulatory restrictions among them—that prevent banks from being merely a component part of a larger enterprise. Because our banking scheme insists on treating the legal entity, which is the bank, with great formality, it does not comport well with the strong form of the enterprise liability idea. Banks are a very special kind of corporation. In a throwback to an earlier time, banking remains one of the few businesses where one must seek a charter from a governmental chartering authority before engaging in business.¹²³ Banks are also special in that they must comply with regulatorily mandated capital requirements.¹²⁴ In addition, the regulatory “firewalls” that separate banks from their affiliates in the bank holding company create two kinds of insulation—financial insulation¹²⁵

120. See Adolph Berle, Jr., *The Theory of Enterprise Entity*, 47 COLUM. L. REV. 343, 350 (1947) (“In effect what happens is that the court, for sufficient reason, has determined that though there are two personalities, there is but one enterprise; and that this enterprise has been so handled that it should respond, as a whole, for the debts of certain component elements of it.”).

121. 321 U.S. 349 (1944).

122. See *id.* at 363.

123. Modern banks seem to be products of the ancient “artificial entity” or “concession” theory of corporation. See Samuel Williston, *History of the Law of Business Corporations Before 1800*, 2 HARV. L. REV. 105, 106 (1888). In a nutshell, that theory of corporateness holds that only the sovereign can give life to a new corporate being, and that the sovereign sometimes may create such a person if, as a quid pro quo, the new corporate person promises in its charter to perform some socially useful activity for the sovereign. See *id.* at 113-14.

124. See Banks and Banking, 12 C.F.R. 208 app. A (1998).

125. Financial insulation includes such things as avoiding “subtle hazards,” see *supra* notes 86-90 and accompanying text, and those transactions prohibited by statute in §§ 23A or 23B of the Federal Reserve Act, 12 U.S.C. §§ 371c, 371c-1 (1994).

and operational insulation¹²⁶—that set banks off in their own special realm. As part of the regulatory approval process, banking regulators routinely require that a holding company's nonbanking affiliates be virtually independent from the bank.¹²⁷

All of this separation of banks from other affiliates in the holding company structure goes a long way toward making it impossible for holding companies to recognize any real synergies or economies of scope from their affiliation with a bank.¹²⁸ Yet despite all of the separateness of banks and the restrictions on their ability to work together with other holding company affiliates, the law is quick to disregard the corporate form of the bank and to try through every means available to impose liability on the holding company for the obligations of the bank.¹²⁹ In light of the special chartering, capital, and regulatory treatment of banks, they seem to deserve *more* respect as impermeable corporate entities than the typical corporation, but they actually receive *less*. The current regulatory scheme makes the elaborate efforts to set banks off as independent entities within the holding company structure appear to be nothing but a charade.

F. Political Explanation

Although it would be intellectually satisfying and perhaps spiritually reaffirming to find a clear and coherent regulatory justification for enhanced holding company obligations that comports with traditional policy goals and withstands close scrutiny in light of empirical evidence, we must be prepared for the possibility that no such justification exists.¹³⁰ Public choice scholars would not hesitate to suggest that

126. See Robert A. Eisenbeis, *Commentary*, in *RESTRUCTURING*, *supra* note 52, at 203, 206 (describing the two types of insulation).

127. The regulators often require the affiliates within a holding company, especially banks and their securities affiliates, to have separate boards, that banks in separate states have separate boards, and that affiliates within a bank holding company adhere to other "firewalls" designed to keep the holding company subsidiaries as "independent" as possible. See, e.g., Citicorp, New York, New York, Order Approving the Acquisition of Savings and Loan Association, 68 Fed. Res. Bull. 656, 656-60 (Oct. 1982) (conditioning regulatory approval of acquisition on, among other things, Citicorp operating its new subsidiary as a "separate, independent, profit-oriented corporate entity").

128. See Eisenbeis, *supra* note 126, at 206 ("Operational insulation would . . . [deny banks] any synergies and scope economies that would come from having a sister broker-dealer affiliate.").

129. See generally Gouvin, *supra* note 15, at 333-45 (discussing the myriad ways of imposing liability on bank holding companies).

130. Cf. R. DOUGLAS ARNOLD, *THE LOGIC OF CONGRESSIONAL ACTION* 47-51 (1990) (From a political point of view, an innocuous or fuzzily defined problem also carries with it the added benefit of being unlikely to come back to haunt the legislator in the next election.); Gouvin, *supra* note 46, at 1327-34 (discussing the systemic mechanisms that militate against a candid statement of policy rationale); Angus A. MacIntyre, *The Multiple Sources of Statutory Ambiguity: Tracing the Legislative Origins of Administrative Discretion*, in *ADMINISTRATIVE DISCRETION AND THE IMPLEMENTATION OF PUBLIC POLICY* 67, 72-74 (Douglas H. Shumavon & H. Kenneth Hibbeln eds., 1986) (noting that proposals must be set forth in somewhat opaque terms to keep their prospects for adoption alive).

the enhanced obligations are not the product of a well-planned regulatory scheme, but rather are merely the result of the give and take of the political marketplace.¹³¹ The increased burdens on holding companies may have come about solely for political reasons—so that Congress could say to a skeptical public, “we’re getting tough on those fat cat holding companies.”

Although in Professor Jackson’s view, a purely political rationale does not provide a regulatory *justification* for the law, it may provide the only meaningful *explanation* for the law.¹³² We should assess whether the regulatory justification we attribute to a given regulatory scheme is a legitimate expression of public policy or merely a *post hoc* rationalization of political action. Dressing up purely political action in terms that make it presentable as a legitimate regulatory decision when it was not in fact inspired by the purported justification is illegitimate.¹³³ While we can criticize the poor fit between the action taken and the purported justification and argue that the action should not stand on its offered justification, sometimes it may be more productive to strip away the purported justification and see the legislation for

131. The scholars who make up the public choice camp are a somewhat loosely knit group. Their perspectives on the law draw heavily on economics, game theory, organizational behavior, and political science. See generally DANIEL A. FARBER & PHILIP P. FRICKEY, *LAW AND PUBLIC CHOICE: A CRITICAL INTRODUCTION* 21-33 (1991); SHAUN H. HEAP ET AL., *THE THEORY OF CHOICE: A CRITICAL GUIDE* 209-15 (1992) (giving a useful overview of the topic, especially of the theoretical problems of aggregating preferences, which tends to make the output of collective bodies incoherent); DANIEL A. FARBER & PHILIP P. FRICKEY, *The Jurisprudence of Public Choice*, 65 TEX. L. REV. 873, 878-79, 883, 901-06 (1987) (stating a general theory of “public choice” is impossible, because there are many variations on the set of core principles that have inspired many of the scholars).

132. As Professor Jackson sees it, a regulatory justification rationalizes government intervention as necessary to control undesirable private conduct. See Jackson, *supra* note 24, at 562. Certainly, there are theories of political justification. See JOHN RAWLS, *POLITICAL LIBERALISM* 146-68 (1993) (providing a theory of political justification based on the idea that the people supporting a political act endorse the act based on grounds supplied to them by their own moral, political, or religious views). A justification must be couched in politically acceptable terms, while an explanation is not so constrained. Some acts of legislatures may not in good faith be supportable by a public policy justification, although their adoption may nevertheless be explained as the convergence of various forces of self-interest. See Gouvin, *supra* note 46, at 1327-34 (discussing the offered explanations for federal truth in savings legislation).

133. Cf. Gouvin, *supra* note 46, at 1327-34 (discussing lack of candor in the legislative process). The subject of candor in the legal system has received extensive attention from legal scholars examining the adjudication process. See Deborah Hellman, *The Importance of Appearing Principled*, 37 ARIZ. L. REV. 1107, 1151 (1995) (noting that the Supreme Court’s concern with stare decisis and other trappings of principled decisionmaking and concluding that it is appropriate that decisions not only be principled, but that they appear principled as well); David L. Shapiro, *In Defense of Judicial Candor*, 100 HARV. L. REV. 731, 736-38 (1987) (arguing that candor establishes the moral authority of the bench and the public trust necessary for the judiciary to function and acts as a restraint on judicial power by requiring a reasoned response to a reasoned argument); Nicholas S. Zeppos, *Judicial Candor and Statutory Interpretation*, 78 GEO. L.J. 353, 401 (1989) (suggesting that candor makes the law predictable by giving parties notice of the real basis for a court’s decision and allowing other courts to follow suit). But see Scott Altman, *Beyond Candor*, 89 MICH. L. REV. 296, 318-27 (1990) (stating that there may be pragmatic reasons, such as creating the appearance of judicial restraint or decreasing the search time for judges and lawyers, for eschewing “introspective” candor and instead employing formalistic techniques of adjudication).

what it is—a rent-seeking wealth transfer from holding companies to politicians, policymakers, the deposit insurance fund, and indirectly, to the taxpayers.¹³⁴

At first blush, this explanation for holding company obligations sounds very similar to the cost-defraying justification discussed above, but it is different in at least two respects. First, the cost-defraying hypothesis by its terms concerns itself with monetary outlays and the need to replenish the depleted insurance fund. In contrast, although transfers of actual dollars might be part of the political explanation, the transfers of importance to the political explanation might include a whole range of nonmonetary rents such as votes, good will, enhancement of public image, and monetary support for political campaigns. Second, the cost-defraying hypothesis is the kind of justification that is appropriate for public dissemination, while the political justification would never be explicitly articulated.¹³⁵

The public choice perspective, of course, has its critics, many of whom make quite convincing arguments.¹³⁶ But one does not need to be a dyed in the wool public choice theorist to hold the view that our regulatory system is subject to sway in the political winds and therefore produce incoherent outcomes. Supreme Court Justice Stephen Breyer, for instance, who is by no means an adherent of the public choice perspective,¹³⁷ has noted the disruptive effects of the political process on coherent regulatory policy in his book, *Breaking the Vi-*

134. See Robert D. Tollison, *Public Choice and Legislation*, 74 VA. L. REV. 339, 343 (1988) (explaining that public choice scholars are likely to see statutes and regulations as products that are bought and sold in economic markets).

135. Because policymakers realize they must be capable of justifying their actions in terms of widely held political values, they are prohibited from being candid about rent-seeking behavior as a reason for a given legislative enactment. See Seidman, *supra* note 46, at 7 (stating that representatives understand that they must be able to justify their actions in terms of the neorepublican ideal).

136. Scholars have attacked the public choice position on the grounds that it lacks empirical support. See, e.g., Janet M. Grenzke, *PACs and the Congressional Supermarket: The Currency Is Complex*, 33 AM. J. POL. SCI. 1, 2 (1989); Mark Kelman, *On Democracy-Bashing: A Skeptical Look at the Theoretical and "Empirical" Practice of the Public Choice Movement*, 74 VA. L. REV. 199, 236-68 (1988). Other scholars have criticized the methodology of the public choice approach for failing to give weight to legitimate concerns about the public interest that legislators may have and instead constructing an ex post explanation for legislative behavior based on who benefitted from the legislation. See, e.g., Donald C. Langevoort, *Statutory Obsolescence and the Judicial Process: The Revisionist Role of the Courts in Federal Banking Regulation*, 85 MICH. L. REV. 672, 692 (1987); Edward L. Rubin, *Beyond Public Choice: Comprehensive Rationality in the Writing and Reading of Statutes*, 66 N.Y.U. L. REV. 1, 5-30 (1991). In addition, many scholars have questioned whether a worldview dominated by interest groups and excluding higher values runs the risk of becoming morally impoverished and ultimately politically illegitimate. See, e.g., Geoffrey Brennan & James M. Buchanan, *Is Public Choice Immoral? The Case for the "Nobel" Lie*, 74 VA. L. REV. 179, 180 (1988) (describing this criticism); Daniel A. Farber, *Democracy and Disgust: Reflections on Public Choice*, 65 CHI.-KENT L. REV. 161, 162 (1989).

137. See Ernest Gellhorn, *Rationalizing Regulatory Reform*, 81 MICH. L. REV. 1033, 1036-37 (1983) (reviewing STEPHEN BREYER, *REGULATION AND ITS REFORM* (1982) and criticizing it for ignoring the perspectives of the public choice literature); Eric J. Gouvin, *A Square Peg in a Vicious Circle: Stephen Breyer's Optimistic Prescription for the Regulatory Mess*, 32 HARV. J. ON LEGIS. 473, 482-83 (1995) (reviewing STEPHEN BREYER, *BREAKING THE VICIOUS CIRCLE: TO-*

cious Circle: Toward Effective Risk Regulation.¹³⁸ Banking regulation appears to be a classic example of what Justice Breyer calls the "random agenda" problem.¹³⁹ The random agenda problem develops when an agency's policies are not guided by rational experts but are instead driven by irrational public fears, politics, history, and even chance.¹⁴⁰ Unfortunately, when a regulator gets trapped in the random agenda problem not only does the agenda fail to address the problems that experts consider the most serious, the perceived problems that it does address change with the political winds.

There is ample anecdotal evidence that the congressional and regulatory response to the thrift and banking crises of the late 1980s was fueled more by public sentiment than careful policy analysis.¹⁴¹ Some believe that the regulators during the Reagan and Bush years were asleep at the switch or that the problems plaguing the system could be corrected with additional regulation.¹⁴² And more regulation is just what the banking industry got. The long list of regulatory weapons devised for use against bank holding companies¹⁴³ illustrates the kind of overreaction described by Justice Breyer.¹⁴⁴

But more regulation is not necessarily better regulation. The policy rationale for bank holding company regulation was already obscure enough before the overreaction to the last banking crisis; piling on more regulation made the purpose of the regulatory scheme even more difficult to divine.¹⁴⁵ If an incoherent politically driven impulse

WARD EFFECTIVE RISK REGULATION (1993) and criticizing Justice Breyer for failing to consider the public choice perspective).

138. See STEPHEN BREYER, *BREAKING THE VICIOUS CIRCLE: TOWARD EFFECTIVE RISK REGULATION* *passim* (1993).

139. See *id.* at 19. Justice Breyer's concern with agendas comports with the concern of other scholars who have studied the role of agendas in the legislative and regulatory process. The control of agendas can have a profound impact on the outcome of the policy process. See generally FARBER & FRICKEY, *supra* note 131, at 39-42; HEAP ET AL., *supra* note 131, at 249-58; Kenneth A. Shepsle, *Prospects for Formal Models of Legislatures*, 10 LEGIS. STUD. Q. 5, 13-14 (1985); Barbara Sinclair, *Agenda Control and Policy Success: Ronald Reagan and the 97th House*, 10 LEGIS. STUD. Q. 291, 300-10 (1985).

140. See BREYER, *supra* note 138, at 20. Consistent with Justice Breyer's anecdotal reports on the hazardous substance regulatory agenda, an empirical study examining the EPA's rulemaking agenda concluded that pressure from Congress "distorts priorities and prevents realistic agenda setting and deadline compliance." Steven J. Groseclose, *Reinventing the Regulatory Agenda: Conclusions from an Empirical Study of EPA's Clean Air Act Rulemaking Progress Projections*, 53 MD. L. REV. 521, 533 (1994).

141. For example, the public and Congress seem to have adopted the view that the thrift and banking crises were the result of widespread fraud, when in fact only 15% of the failures were attributable to fraud. See Albert R. Karr, *In Cold Pursuit: RTC Chases Billions from Failed Thrifts, but Nets Small Change*, WALL ST. J., Sept. 2, 1994, at A1.

142. See Lawrence G. Baxter, *Fiduciary Issues in Federal Banking Regulation*, LAW & CONTEMP. PROBS., Winter 1993, at 7, 36 (describing the criticism of the regulators' role in the 1980s).

143. See sources cited *supra* note 15.

144. See BREYER, *supra* note 138, at 39-42.

145. See Manuel A. Utset, *The Discipline of Institutions and the Disciplining of Banks*, 14 ANN. REV. BANKING L. 211, 217 (1995) (saying of increased banking regulation, it "is as if we had a pair of glasses on and could not see very clearly, and proceeded to place five more pairs of glasses on top of the first one. After a while things become quite blurry.").

to regulate is the only explanation for the current scheme of bank holding company obligations, we ought to rethink the entire edifice and start from a new theoretical foundation.

The justifications that have been offered for the imposition of enhanced obligations on bank holding companies are not compelling enough to disregard the corporate forms that make up the holding company structure. At present, the regulatory scheme lacks a principled rationale for ignoring the separate corporate entities in the holding company system. We turn now to the development of a better approach to bank holding company obligations.

III. RETHINKING THE EXTENT OF HOLDING COMPANY LIABILITY

The current array of regulatory devices that impose liability on bank holding companies seems to be the product of an incoherent mix of theoretical justifications.¹⁴⁶ The law does not seem to rest on one consistent view of the relationship between a bank and the holding company that owns it. Consequently, this lack of a clear justification results in a hodgepodge of regulatory devices that are trying to achieve the same goal, yet are inconsistent and apply in different situations. The source of strength doctrine,¹⁴⁷ for example, is essentially an open-ended full liability regime that disregards traditional legal forms—in the nature of a true enterprise liability approach.¹⁴⁸ In light of the difficulties the regulators have encountered in applying the source of strength doctrine,¹⁴⁹ however, they have, with Congress's assistance, cobbled together a diverse collection of other devices that are not necessarily justified on the same grounds as the source of strength doctrine.

The cross-guarantee provisions,¹⁵⁰ for instance, appear to rest primarily on the cost-defraying justification¹⁵¹ and only apply when the holding company owns more than one bank. Regulatory agreements,

146. Although it is possible to view all of the holding company liability devices through one lens, such as the market discipline perspective, *see* Gouvin, *supra* note 15, at 333-45, each individual device has its own regulatory justification and may or may not have been inspired by the market discipline idea.

147. It should be noted that the source of strength doctrine is based on Federal Reserve Board policy, not on legislative mandate. The "source of strength" doctrine is codified in the FRB's Regulation Y, which states that "[a] bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks." 12 C.F.R. § 225.4(a) (1996).

148. *See* BLUMBERG, STATUTORY LAW, SPECIFIC, *supra* note 116, at 992-94; Sommer, *supra* note 9, at 229 ("[T]he banking industry utilizes legal devices that apparently confer legal personality on the subsidiary without conferring limited liability on the parent.").

149. *See* MCorp Fin., Inc. v. Board of Governors, 900 F.2d 852, 860-62 (5th Cir. 1990), *rev'd on other grounds*, 502 U.S. 32 (1991) (finding that the FRB exceeded its statutory authority by using the source of strength doctrine to require a holding company to transfer funds to its subsidiary banks). *See generally* Bierman & Fraser, *supra* note 21 (addressing controversy surrounding the promulgation and application of the source of strength doctrine).

150. *See* 12 U.S.C. § 1815(e) (1994).

151. The cross-guarantee provisions permit the receiver of a failed institution to recover the costs incurred in resolving the failed institution from the sister banks within the holding com-

another approach to holding company liability, seem to be grounded more on the market discipline idea,¹⁵² but also arise only in the context of applications or other extraordinary events.¹⁵³ Capital restoration plans¹⁵⁴ may be justified on specialness¹⁵⁵ or market discipline¹⁵⁶ grounds, but again arise only in special situations and even then are not mandatory.¹⁵⁷ The use of equitable subordination,¹⁵⁸ preference,¹⁵⁹ and fraudulent conveyance¹⁶⁰ law in the holding company context would seem to be inspired primarily by the hungry wolf hypothesis,¹⁶¹ but these approaches, too, only apply in certain appropriate fact situations. Finally, the idea of a free-floating fiduciary duty to the banking regulators¹⁶² seems grounded on its own unique theory

pany system. It is entirely geared to costs and has less explicit support under the other justifications discussed. *See supra* notes 17-19 and accompanying text.

152. Regulatory agreements generally focus on making sure that the party in control of the institution injects sufficient capital to exercise close monitoring of banking operations. These regulatory agreements sometimes take the form of an "affidavit" or "stipulation" signed by the party seeking control of the financial institution. Sometimes the agreement takes the form of letters between the regulator and the acquiring party, and, more recently, the agreements have taken the form of a formal "capital maintenance agreement," signed by the regulator and the acquiror. *See* Paul L. Lee, *Liability of Bank Holding Companies, Savings and Loan Holding Companies and Their Affiliates for Failed Bank and Thrift Subsidiaries*, in *COUNSELLING CREDITORS OF BANKS AND THRIFTS: DEALING WITH THE FDIC AND RTC* 379 (PLI Commercial Law & Practice Course Handbook Series No. 561, 1991).

153. For example, thrift regulators have the power to require persons seeking control of savings and loan associations to enter into a contractual version of the source of strength doctrine. *See* 12 C.F.R. § 571.6(d)(4) (1996) (describing imposition of net worth maintenance agreements in connection with the requirements for obtaining a de novo charter for an association).

154. *See* 12 U.S.C. § 1831o(e)(2) (1994).

155. Institutions defined as "undercapitalized" are required to submit a Capital Restoration Plan to the institution's federal banking agency. *See* § 1831o(e)(2)(D)(ii). To the extent the capital restoration idea is designed to prevent undercapitalized institutions from failing, it seems grounded on the specialness justification.

156. The capital restoration plan approach is also designed to get holding companies more actively involved in the operation of their bank subsidiaries by raising the financial stakes of bank failure. If a bank holding company controls the undercapitalized financial institution, FDICIA prohibits regulatory approval of the Capital Restoration Plan unless the holding company guarantees compliance with the CRP for one year and provides adequate assurances of compliance. *See* § 1831o(e)(2)(C)(ii)(I).

157. *See* Gouvin, *supra* note 15, at 338-39.

158. The FDIC has adopted a policy of equitably subordinating the interaffiliate claims between banks and other members of the holding company family when resolving a failed bank. *See, e.g.,* Texas Am. Bancshares, Inc. v. Clarke, 740 F. Supp. 1243, 1251-53 (N.D. Tex. 1990), *rev'd*, 954 F.2d 329 (5th Cir. 1992); MBank New Braunfels, N.A. v. Federal Deposit Ins. Corp., 721 F. Supp. 120, 126 (N.D. Tex. 1989).

159. *See* 12 U.S.C. § 91.

160. The statutory standard permits a receiver or conservator for an insured depository institution to avoid certain transfers made with the intent to hinder, delay, or defraud the depository institution, the FDIC or any other appropriate federal banking agency. *See* 12 U.S.C. § 1821(d)(17)(A).

161. All three techniques are designed to undo interaffiliate transactions on the apparent ground that those transactions are unfair to other parties that have claims against the failed institution. This comports with the hungry wolf idea, *see* text accompanying *supra* notes 83-90.

162. Some federal banking regulators have discussed the existence of a fiduciary duty running from the insured financial institution directly to the insurance fund. In a 1990 speech that drew analogies to the law of bankruptcy, Harris Weinstein, Chief Counsel to the Office of Thrift Supervision, concluded that insured banks and their fiduciaries owe the federal government a

but disregards some traditional precepts of corporate and banking law.¹⁶³ Given the incoherence of this area, the whole range of approaches should be scrapped and replaced with a more defensible and coherent approach.¹⁶⁴

What is the appropriate degree of holding company liability? This part addresses this issue by examining possible liability schemes, starting with the premise that some amount of holding company liability is desirable in some situations. First, the extremes—total liability or no liability for bank failure—are discussed. Next, the spectrum of liability schemes between these extremes is evaluated before finally developing the horizontal conflict justification.

A. *Examining the Extremes*

1. *Strong Deference to Juridical Form*

In setting the appropriate balance between bank holding company and bank subsidiary liability, one could conceive of a scheme that respects the legal entities in the corporate family and does not impose the subsidiary's liabilities on the parent. Under such an approach, the only recourse available to a claimant with an unfulfilled claim against the subsidiary bank would be traditional piercing the veil jurisprudence, in which courts will disregard the corporate form when it is necessary to prevent "injustices or inequitable consequences."¹⁶⁵ Piercing the corporate veil is, and should be, a rare event. Although some commentators have suggested that courts may be more willing to pierce the corporate veil of the subsidiary to reach the

general fiduciary duty "not to risk insolvency and the resulting loss of funds deposited with the institution." *Speech by OTS Chief Counsel Weinstein on Duties of Depository Institution Fiduciaries*, [July-Dec.] *Banking Rep.* (BNA) No. 12, at 511 (Sept. 24, 1990).

163. See Baxter, *supra* note 142, at 16-21 (demonstrating that although a fiduciary duty to the regulator is theoretically plausible, Congress has already supplanted the need for a general fiduciary duty by enacting a detailed regulatory scheme and imposing the duty to act safely and soundly); Keith R. Fisher, *Nibbling on the Chancellor's Toesies: A "Roguish" Concurrence with Professor Baxter*, *LAW & CONTEMP. PROBS.*, Winter 1993, at 45, 56 (pointing out that the new fiduciary duty would be imposed on parties, such as attorneys, whose fiduciary duty runs only to the client, with no direction on how to accommodate the new duty); Andrew J. Nussbaum, *Like Money in the Bank? An Economic Analysis of Fiduciary Duties to Protect the S&L Deposit Insurance Fund*, 44 *ADMIN. L. REV.* 355, 362-66 (1992) (employing portfolio theory to show the economic inefficiency of such a rule and its negative consequences).

164. Others who have considered the idea have reached the same conclusion, although we differ in the details of how to replace the current system. See Bierman & Fraser, *supra* note 21, at 281-84 (recommending repeal of the prompt corrective action provision and replacement of it with alternative deposit insurance reforms); Broome, *supra* note 29, at 967-1004 (reviewing the range of enhanced holding company obligations and concluding that the regulatory scheme would work better if the liability of holding companies were more open ended); Havard, *supra* note 28, at 2375-2412 (criticizing the source of strength doctrine, regulatory agreements, and the prompt corrective action provisions and suggesting the use of substantive consolidation of bank subsidiaries to shore up a failing bank); Jackson, *supra* note 24, app. at 615-16 (noting that the current approaches lack consistency and should be replaced by a more coherent approach to holding company obligations).

165. *Kinney Shoe Corp. v. Polan*, 939 F.2d 209, 211 (4th Cir. 1991).

parent corporation,¹⁶⁶ a recent empirical study of reported cases does not support such a claim.¹⁶⁷

This scheme would be an unacceptable approach to holding company liability because in some situations bank subsidiaries may fail in part because they have acted in the holding company's behalf but did not commit a piercing the veil type bad act.¹⁶⁸ For example, decisions that subsidiary bank's directors make may be focused primarily on shareholder profit maximization—a goal that is well established in corporate law as an important duty of directors¹⁶⁹—but the result of that focus may be to neglect or reject other policy options that were beneficial to the corporate entity as an entity.¹⁷⁰ The elevation of shareholder interests may be entirely legitimate without the other trappings necessary to make such action suspect under piercing the veil jurisprudence. Of course, a regime that respects legal forms could nevertheless in some cases reach a holding company if the subsidiary device was being employed as a way to “avoid a clear legislative purpose.”¹⁷¹ This approach might be used to reach bank holding compa-

166. See William P. Hackney & Tracey G. Benson, *Shareholder Liability for Inadequate Capital*, 43 U. PITT. L. REV. 837, 873 (1982); see also FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 56 (1991) (“Courts’ greater willingness to allow creditors to reach the assets of corporate as opposed to personal shareholders is again consistent with economic principles.”); Robert W. Hamilton, *The Corporate Entity*, 49 TEX. L. REV. 979, 992-94 (1971) (“[C]ourts are probably more willing to ‘pierce the corporate veil’ when the defendant is a corporation rather than an individual.”); Jonathan M. Landers, *A Unified Approach to Parent, Subsidiary and Affiliate Questions in Bankruptcy*, 42 U. CHI. L. REV. 589, 619 (1975) (suggesting that the idea of limited corporate liability was never historically intended to shield parent corporations from obligations of subsidiary corporations).

167. See Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1056-57 (1991) (study found that of the 2000 reported cases analyzed, courts were actually *less* likely to pierce the corporate veil of a subsidiary to reach the corporate parent than they were to pierce the veil of a corporation to reach a shareholder that is a natural person).

168. Some of the specific reasons courts have given for disregarding the separate legal personalities of corporations include to prevent an unfair or inequitable result, “(1) when [the corporate form] is used as a means of perpetrating fraud; (2) where a corporation is organized and operated as a mere tool or business conduit of another corporation; (3) where the corporate fiction is resorted to as a means of evading an existing legal obligation; (4) where the corporate fiction is employed to achieve or perpetuate monopoly; (5) where the corporate fiction is used to circumvent a statute; and (6) where the corporate fiction is relied on as a protection of crime or to justify wrong.” *Castleberry v. Branscum*, 721 S.W.2d 270, 271-72 (Tex. 1987) (footnotes omitted).

169. See *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919) (providing the classic statement that “[a] business corporation is organized and carried on primarily for the profit of the stockholders”).

170. See, e.g., *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1154 (Del. 1990) (acknowledging that the corporation's interests and the shareholders' interests do not always coincide by noting that: “The fiduciary duty to manage a corporate enterprise includes the selection of a time frame for the achievement of *corporate goals*. That duty may not be delegated to the *stockholders*.” (emphasis added)).

171. See *First Nat'l City Bank v. Banco Para el Comercio Exterior de Cuba*, 462 U.S. 611, 630 (1983) (“[T]he Court has consistently refused to give effect to the corporate form where it is interposed to defeat legislative policies.”); *Schenley Distillers Corp. v. United States*, 326 U.S. 432, 437 (1946) (“[C]orporate entities may be disregarded where they are made the implement for avoiding a clear legislative purpose.”).

nies found to be involved in "unsafe or unsound" banking practices¹⁷² or other activities that have been the subject of congressional action.¹⁷³ That mechanism for imposing liability on bank holding companies would probably prove very cumbersome in practice.

2. *Complete Enterprise Liability Treatment*

At the other extreme on the continuum of possible liability regimes, one could conceive of a scheme where all of the liabilities of the bank subsidiaries are imposed directly on the holding company. As a policy matter, however, completely disregarding the corporate forms goes too far. There should be some significance to the legal formalities of separate corporate entities because the regulators make holding companies form these entities and respect the divisions between them.¹⁷⁴ To ignore all of the corporate formalities would make the regulatorily mandated corporate structure nothing more than a costly charade.

The most troublesome aspect of a completely open-ended enterprise liability scheme is the failure to give weight to bank capital requirements. Banks are required to maintain significant capital on their balance sheets.¹⁷⁵ On the other hand, most nonbanking firms in our economy are allowed to engage in business with no specific required amount of capital.¹⁷⁶ When these unregulated nonbank firms fail, the law does not automatically impose liability on the equityholders of those firms. Ironically, while the law mandates levels of "adequate" capitalization for banks,¹⁷⁷ it also automatically holds bank holding companies liable if a controlled bank fails. This is odd in the extreme—why have the minimum capital requirements if the holding company cannot escape liability (or at least some of it) by maintaining an adequately capitalized subsidiary? If the capital requirements are

172. See *Overdrafts and Correspondent Banking Practices: Hearings Before the Senate Comm. on Banking, Housing & Urban Affairs*, 95th Cong., 50 (1977) (statement of George LeMaistre, Chairman, Federal Deposit Insurance Corporation), quoted in EDWARD L. SYMONS, JR. & JAMES J. WHITE, *BANKING LAW* 553-54 (3d ed. 1991) ("Generally speaking, an 'unsafe or unsound' practice embraces any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the insurance fund administered by the corporation.").

173. Cf. *Anderson v. Abbott*, 321 U.S. 349 (1944), discussed in *supra* text accompanying notes 121-23.

174. See *supra* note 127.

175. See Federal Reserve System Capital; Risk-Based Capital Guidelines, 12 C.F.R. pt. 208.13 & app. A (1998); FDIC Capital Maintenance; Statement of Policy on Risk-Based Capital, 12 C.F.R. §§ 325.1-105 (1998); Comptroller of the Currency Risk-Based Capital Guidelines, 12 C.F.R. §§ 3.1-100 (1998).

176. See BAYLESS MANNING & JAMES J. HANKS, JR., *LEGAL CAPITAL* 21 (3d ed. 1990) (noting that U.S. law does not specify realistic, i.e., nonnominal, capital requirements for most corporations, but does make special rules for banks, insurance companies, and corporate trustees).

177. The law classifies banks into five categories, "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized." See 12 U.S.C. § 1831o (1994).

set at the appropriate level, they should provide sufficient protection for parties dealing with the bank without recourse to the holding company. Minimum capital requirements provide more protection for depositors and others dealing with the bank than most people receive from their employers, customers, or vendors, yet the owners of the bank receive little recognition for the benefit they provide.

If heavy capital requirements do not result in heightened respect for the bank as a separate legal entity, the need for bank capital requirements at all might legitimately be questioned in a holding company structure. Not only does the liability of holding companies in light of the capital requirements not make sense as a matter of logic, the application of such an approach creates a disparity between banks owned by holding companies and banks owned by individual shareholders. In the former case, the regulators can access additional resources of the holding company through several regulatory devices, while in the latter case, once the bank's capital is exhausted, the shareholders are not personally liable for additional contributions to the failed enterprise.¹⁷⁸

Although banks sometimes fail because of conditions beyond anyone's control,¹⁷⁹ the impetus to impose liability on bank holding companies seems to flow from the suspicion that when a bank fails the holding company must have had something to do with it. This is really a manifestation of the hungry wolf idea.¹⁸⁰ The empirical evidence refutes the concerns that form the foundation of the hungry wolf hypothesis,¹⁸¹ so if this is the justification for the current scheme of holding company liability, the scheme ought to be reconsidered. On the other hand, if the bank does fail because of holding company abuse, the law should provide a mechanism to recover damages from

178. Although there has been academic debate over the appropriateness of limited liability, corporations continue to provide limited liability to their shareholders in the ordinary course of events. For a review of one particularly vigorous debate, see Janet Cooper Alexander, *Unlimited Shareholder Liability Through a Procedural Lens*, 106 HARV. L. REV. 387 *passim* (1992) (pointing out procedural obstacles to the Hansmann and Kraakman approach); and Joseph A. Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 YALE L.J. 387, 411-15 (1992) (pointing out various dynamics present in the capital markets that would develop and likely frustrate the Hansmann and Kraakman approach). Cf. Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 *passim* (1991) (suggesting an alternative regime to traditional limited liability).

179. See CBO STUDY, *supra* note 100, at 20 (showing that at least 35% of all bank failures were attributable to "external economic conditions"). A series of papers commissioned by the FDIC concluded that the banking crises of the 1980s and 1990s were caused by a number of factors, including severe economic downturns caused by the collapse in energy prices, real estate-related downturns, the agricultural recession of the early 1980s, an influx of banks chartered in the 1980s, prohibitions against branching that limited banks' ability to diversify their loan portfolios geographically and to fund growth through core deposits, and the failure of a single large bank in the state or a number of relatively large banks. See George Hanc, *The Banking Crises of the 1980s and Early 1990s: Summary and Implications*, in 1 HISTORY OF THE EIGHTIES: LESSONS FOR THE FUTURE 3, 16 (Federal Deposit Ins. Corp. ed., 1997).

180. See *supra* notes 83-90 and accompanying text.

181. See *supra* note 89 and accompanying text.

the holding company for the harm created by the holding company's abuse.

Unless the holding company is in some way responsible for the financial distress of the bank, however, it is hard to justify placing financial responsibility anywhere other than on the parties that had claims on the institution. In the nonbanking context, this is an uncontroversial proposition, because one of the primary reasons for forming subsidiaries is to limit the parent's liability.¹⁸² In recent years, a great deal has been written defending limited liability in the corporate context.¹⁸³ Although very little of that scholarship focuses specifically on the special case of subsidiary corporations,¹⁸⁴ Professor Philip Blumberg has concluded that many of the theoretical factors justifying limited liability for corporations generally are irrelevant in the subsidiary context.¹⁸⁵ Others have argued that the limited liability aspect of the subsidiary is economically inefficient and therefore undesirable.¹⁸⁶ Even in light of the argument that subsidiaries do not make a compelling case for the imposition of a limited liability regime, Congress and the FDIC nevertheless have recognized that there should be some limit to the exposure holding companies face as a result of the failure of a banking subsidiary. Congress has refused to disregard completely the corporate forms of banks and their parent holding companies despite years of urging by the FDIC to require that holding companies

182. See ROHRLICH, *supra* note 9, § 12.02, at 508-15 (citing various legal reasons for subsidiary formation such as to limit liability, to avoid restrictions in the parent's charter or restrictions arising under law, for tax reasons, and to avoid complications arising from "foreign corporation" status; also citing nonlegal reasons such as increasing the morale of the subsidiary's management, settling shareholder disputes, and aiding public relations purposes).

183. See EASTERBROOK & FISCHER, *supra* note 166, at 41-44; Richard A. Booth, *Limited Liability and the Efficient Allocation of Resources*, 89 Nw. U. L. REV. 140, 165 (1994) (viewing the primary purpose of limited liability to be the elimination of barriers between corporations and their creditors); Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 Md. L. REV. 80, 130 (1991) (examining and rejecting the idea that limited liability is a privilege granted by the state; finding instead that limited liability is the product of private ordering and thereby compels the acceptance of the contract theory of the corporation).

184. Exceptions include EASTERBROOK & FISCHER, *supra* note 166, at 56-57; Richard A. Posner, *The Rights of Creditors of Affiliated Corporations* 43 U. CHI. L. REV. 499, 509-16 (1976); and, of course, BLUMBERG, *SUBSTANTIVE COMMON LAW*, *supra* note 116. Professor Blumberg has summarized the various advantages of limited liability as (1) permitting absentee investors to avoid exposure to risk; (2) permitting large-scale enterprise; (3) permitting diversification of portfolios; (4) avoiding increased agency costs; (5) avoiding impairment of the efficient capital market; (6) avoiding increased collection costs for creditors; (7) avoiding the costs of contracting around liability; and (8) encouraging risk taking. The disadvantages of limited liability generally are (1) unfairness and inefficiency for tort and other involuntary creditors; (2) unfairness and inefficiency for labor claimants; (3) the encouragement of excessive risk taking; (4) increased information and monitoring costs; (5) impairment of the efficiency of the market; and (6) the possibility of misrepresentation. See BLUMBERG, *SUBSTANTIVE COMMON LAW*, *supra* note 116, §§ 402-403, at 66-84.

185. See BLUMBERG, *SUBSTANTIVE COMMON LAW*, *supra* note 116, § 5.01, at 93.

186. See Sommer, *supra* note 9, at 231-42.

use all available assets—including the assets on nonbank subsidiaries—to cover the costs of a failed bank.¹⁸⁷

Even though the FDIC would have preferred a congressionally endorsed open-ended enterprise liability regime, it eventually settled for implementation of the cross-guarantee provisions of FIRREA¹⁸⁸ as the viable alternative to the approach it had originally supported. In justifying its support for cross guarantees, the FDIC noted that the open-ended source of strength approach disregards distinctions between the separate corporate entities within a bank holding company system and puts a bank holding company's nonbank assets at risk when a bank subsidiary fails.¹⁸⁹ The FDIC believed that this exposure of nonbanking assets could present a major obstacle to nonbanking firms entering the banking industry and could thereby present an obstacle to increased competition.¹⁹⁰

As neither absolute respect for the legal entities in a holding company system nor complete disregard for the corporate entities seems appropriate, examining the continuum between the two extremes may yield a more defensible position.

B. *Exploring the Middle Ground*

If a scheme that has no respect for the corporate forms and a scheme that respects the corporate forms above all else are both unacceptable, where should the line between the two extremes be drawn? It is possible for the law to fashion a scheme that both imposes liability on parent corporations and gives an appropriate amount of respect to the corporate form. Applying some degree of holding company liability in appropriate contexts is not inconsistent with respecting corporate personality.¹⁹¹ First, in corporate law, the idea of complete

187. For instance, the FDIC championed a bill in 1988 that would have given the FRB the power, at the FDIC's request, to compel bank holding companies and their nonbank subsidiaries to transfer "such assets or services as are customarily utilized by a bank in the conduct of its business or operations" to failing banks owned by the holding company. Emergency Bank Consolidation Act of 1988, S. 2715, 100th Cong., 134 Cong. Rec. S21,601 (daily ed. Aug. 10, 1988).

188. See 12 U.S.C. § 1815(e) (1994); *supra* notes 17-19 and accompanying text.

189. See FDIC, DEPOSIT INSURANCE FOR THE NINETIES: MEETING THE CHALLENGE, ch. 7, at 33-34 (1989) (draft). It should be noted, however, that during 1986 and 1987, the last years for which reliable data is available, nonbank activities constituted a small part of the total assets of most banking organizations. NELLIE LIANG & DONALD SAVAGE, BOARD OF GOVERNORS OF THE FED. RESERVE SYS., NEW DATA ON THE PERFORMANCE OF NONBANK SUBSIDIARIES OF BANK HOLDING COMPANIES, STAFF STUDY 159, at 12 (1990). Some of the nation's largest banking institutions, however, have a very large commitment to nonbank activities, as evidenced by the fact that the top 100 bank holding companies required to report their nonbanking activities to the Federal Reserve Board held 99% of all the nonbanking assets reported. See *id.*

190. See FDIC, *supra* note 189, at 33-34.

191. The idea of subsidiaries as independent legal persons is tied up in 19th century ideas about corporate personality. Several excellent treatments of corporate theory examine the intellectual history of the idea of the corporation. For general background on this topic, see HERBERT HOVENCAMP, ENTERPRISE AND AMERICAN LAW 1836-1937, at 1-16 (1991); JAMES W. HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 1780-1970, at 4 (1970); Phillip I. Blumberg, *The Corporate Entity in an Era of Multinational Corpora-*

limited liability for shareholders is a relatively recent development.¹⁹² The relatively recent advent of limited shareholder liability is especially novel in the banking business, which until comparatively recently imposed liability on shareholders in cases of bank failure.¹⁹³ Of course, courts will pierce the corporate veil when necessary to reach the shareholders of a corporation.¹⁹⁴

Second, imposing some obligations of subsidiaries directly on their parent corporations does not have to involve "piercing the veil"—but may instead respect traditional notions of corporate personality by relying on other legal theories such as agency law.¹⁹⁵ It is arguable, for instance, that by the mere fact of the corporate family structure, subsidiary directors do not act independently in the best interest of the subsidiary corporation, but instead merely do the bidding of the parent who placed them in the director position.¹⁹⁶ Finding the parent liable for the acts of its agents who are serving as directors of subsidiary corporations does not constitute "piercing the veil" of the subsidiary.¹⁹⁷ In fact, English company law has a mechanism specifically designed to reach this situation, the idea of the "shadow direc-

tions, 15 DEL. J. CORP. L. 283, 291-99 (1990); Morton J. Horwitz, *Santa Clara Revisited: The Development of Corporate Theory*, 88 W. VA. L. REV. 173, 178-83 (1985); David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201, 205-11.

192. As Professor Blumberg has pointed out, the doctrine of limited liability for shareholders from corporate debts was not established until 1830 in the United States and not until 1855 in England. See Blumberg, *supra* note 117, at 297. More pointedly, Professor Horwitz has noted,

It is not usually appreciated that truly limited shareholder liability was far from the norm in America even as late as 1900. . . . [T]he distinction between the liability of the "members" of a corporation and a partnership, so clear to modern eyes, was still regarded rather as a matter of degree than of kind throughout the nineteenth century.

Horwitz, *supra* note 191, at 208. Not only were shareholders not protected from liability, but in some industries, notably insurance, directors could also be personally liable for corporate acts. See EDWIN MERRICK DODD, *AMERICAN BUSINESS CORPORATIONS UNTIL 1860*, at 304-05 (1954).

193. See generally Macey & Miller, *supra* note 30, at 31 (describing the old approach to double liability for bank shareholders).

194. See *supra* notes 165-71 and accompanying text.

195. There is support in case law for treating agency as an alternative route to veil piercing for imposing liability on a parent corporation. See, e.g., *Royal Indus. Ltd. v. Kraft Foods, Inc.*, 926 F. Supp. 407, 412 (S.D.N.Y. 1996); *National Council on Compensation Ins. v. Hopkins*, No. 1:92-CV-082, 1995 U.S. Dist. LEXIS 21030, at *79-80 (E.D. Tenn. Dec. 19, 1995).

196. One could argue that this article's assumption that subsidiary directors will only do the bidding of the corporate parent is not empirically sound. Evidence from some cases supports a contrary assertion. See, e.g., *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1119-20 (1991) (Kennedy, J., concurring in part and dissenting in part) (noting the different courses of action pursued by different boards of commonly controlled subsidiaries in the face of potential overreaching by the parent). It is worth noting, however, that even in *Virginia Bankshares*, the directors of one subsidiary acted as the holding company wanted them to act, without seriously questioning the holding company's position. Even if occasionally subsidiary directors will stand up to parental pressures, it would seem a fair assumption that such action places the directors in an especially uncomfortable position. Furthermore, the dilemma faced by subsidiary directors will not be automatically cured by a requirement that the directors be independent or "outside" directors, because the empirical data on outside directors as monitors is decidedly mixed. See Lin, *supra* note 101, at 939-61 (discussing empirical studies of outside director effectiveness).

197. See Hamilton, *supra* note 166, at 983-84.

tor,"¹⁹⁸ even though English courts notoriously loathe actually piercing the corporate veil.¹⁹⁹

Breaking through the legal entity of the subsidiary to reach the parent corporation may be appropriate in situations where the holding company has in some way contributed to the demise of the bank, even if only to the extent that the holding company's looming presence made the subsidiary's directors disregard their duties to nonshareholders, including their duty to act in the best interest of the bank as a bank. Given that there is some legal justification for imposing a duty on parent corporations, the issue of how much liability is appropriate still must be addressed. The question is difficult to answer without a rigorous regulatory justification to provide guidance.

An acceptable regulatory justification must take into account, and create a mechanism to resolve, the catch-22 that currently faces bank managers. As presently structured, the banking regulatory scheme puts bank directors in an untenable position. Although the banking law is sometimes perceived to rest on enterprise liability principles,²⁰⁰ it nevertheless also persists in at least giving lip service to the idea that bank holding companies and their subsidiaries are independent corporations.²⁰¹ Treating banks simultaneously as both independent entities and mere components of the holding company enterprise creates some unfair results for the managers of bank subsidiaries.

Directors of bank subsidiaries are judged by rules fashioned for the directors of independent corporations and as a result are often held liable for bank failures.²⁰² Even though it is unrealistic to expect the directors of a subsidiary to make decisions that take into account any interests other than the shareholder's, the FDIC as receiver of the failed bank frequently asserts claims belonging to the bank for breaches of fiduciary duty arising out of the directors' failure to make decisions in the best interests of the bank as a bank.²⁰³

Subsidiary bank directors' potential of personal liability²⁰⁴ for failure to act in the best interest of the bank creates a disincentive for

198. See Daniel D. Prentice, *Some Aspects of the Law Relating to Corporate Groups in the United Kingdom*, 13 CONN. J. INT'L L. 305, 326 (1998) (describing the shadow director as a person, which can include a corporation, "in accordance with whose directions or instructions the directors of the company are accustomed to act" (quoting Insolvency Act, 1986, § 214(T) (Eng.))).

199. See *id.* at 24-28 (discussing the reasons for the durability of *Salomon v. Salomon & Co. Ltd.*, a landmark 19th-century case that refused to pierce the corporate veil).

200. See BLUMBERG & STRASSER, STATUTORY LAW: SPECIFIC, *supra* note 116, at 992-94; Sommer, *supra* note 9, at 229 ("[T]he banking industry utilizes legal devices that apparently confer legal personality on the subsidiary without conferring limited liability on the parent.").

201. See *supra* text accompanying notes 123-28.

202. See Gouvin, *supra* note 32, at 288-92.

203. See *infra* note 220.

204. Although bank directors should be covered by directors' and officers' liability insurance, the types of claims brought against them in these situations were often excluded from coverage. In many situations the specific claims asserted by the FDIC fall into the standard insurance exclusions for violations of regulations or for suits by the insured against itself. See M.

qualified persons to serve as directors²⁰⁵ and is unfair. The unfairness stems from the inappropriate application of the independent entity model to the subsidiary corporation and the failure to recognize that subsidiary directors are trapped in an intractable horizontal conflict.

C. *Developing the Horizontal Conflict Justification*

If banks are not special, they should be treated as other corporations are treated in the context of parent liability for subsidiary obligations.²⁰⁶ Unfortunately, how parents and subsidiaries are treated depends on a number of context-specific factors that elude concise formulation.²⁰⁷ In the context of wholly owned subsidiaries, including bank subsidiaries of bank holding companies, however, one important dynamic should be taken into account: if subsidiary directors are to be charged with duties to nonshareholder constituencies,²⁰⁸ those duties

Mazen Anbari, Comment, *Banking on a Bailout: Directors' and Officers' Liability Insurance Policy Exclusions in the Context of the Savings and Loan Crisis*, 141 U. PA. L. REV. 547, 551 (1992); see also *Chandler v. American Cas. Co.*, 833 F. Supp. 735, 737 (E.D. Ark. 1993) (deciding that claim by Resolution Trust Corporation is also within exclusion); *Abifadel v. Cigna Ins. Co.*, 9 Cal. Rptr. 2d 910 (Ct. App. 1992) (regulatory agency directives do not constitute covered claims). But see *Federal Deposit Ins. Corp. v. American Cas. Co.*, 843 P.2d 1285, 1290-91 (Colo. 1992) (stating that insurer's "regulatory exemption" deemed against public policy because it prohibits the FDIC from bringing suit to protect the interest of depositors, creditors, and stockholders). For a general discussion of directors' and officers' liability insurance, see Joseph P. Monteleone & Nicholas J. Conca, *Directors and Officers Indemnification and Liability Insurance: An Overview of Legal and Practical Issues*, 51 BUS. LAW. 573, 587-607 (1996); Bennett L. Ross, Note, *Protecting Corporate Directors and Officers: Insurance and Other Alternatives*, 40 VAND. L. REV. 775, 775-76 (1987). In successful suits not covered by insurance, the recovery comes out of the directors' personal assets.

205. The potentially tremendous personal exposure facing bank directors has made the recruitment of qualified directors increasingly difficult. See Dan Cordtz & Jennifer Reingold, *The Vanishing Director*, CORP. FIN., Fall 1993, at 34, 34-40; *Liability Concerns Shrink Pool of Directors*, A.B.A. BANKING J., Oct. 1992, at 105; Barbara A. Rehm, *Fearing Lawsuits, Bank Directors Take a Hike*, BANKING WK., Jan. 6, 1992, at 1, 1. Even persons serving as "honorary" directors with such titles as "associate director," "advisory director," or "director emeritus" may find themselves subject to personal liability. See Charles M. Moore & Leonard H. Plog II, *Honorary Directors of Financial Institutions: More Liability, Less Honor*, 109 BANKING L.J. 233, 233-34 (1992) (noting that persons who serve in such honorary positions can no longer assume that their titles alone shield them from liability).

206. Of course, the parent-subsidiary relationship poses special problems for corporate law. See, e.g., Gouvin, *supra* note 32, at 287-94 (introducing the theoretical inconsistencies in judging the actions of subsidiary directors under rules designed for directors of independent corporations).

207. Professor Blumberg's exhaustive treatise provides evidence of this idea. The work discusses myriad approaches to enterprise liability in various situations. See sources cited *supra* note 116. Another of his books provides a concise overview of enterprise principles and adds a comparative law discussion. See generally PHILLIP I. BLUMBERG, *THE MULTINATIONAL CHALLENGE TO CORPORATION LAW* (1993).

208. Case law suggests that corporate directors generally may owe duties to a number of nonshareholder constituents, including creditors, depositors, insurance policy holders, and to the corporation itself as an entity separate and distinct from the shareholders. See Gouvin, *supra* note 32, at 297-300, 307-15. In some jurisdictions statutes require or at least permit corporate directors to consider the interests of nonshareholders when making corporate decisions. For a general discussion of corporate constituency statutes, see Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14 *passim* (1992) (offering a critical framework for interpreting the statutes); see also MARGARET M. BLAIR, *OWNERSHIP*

are likely to be neglected because the management of a subsidiary is frequently enslaved to the holding company. Although the existence of any real duty to nonshareholders may be subject to debate in the corporate law generally, banks and bank directors clearly owe duties to nonshareholders.²⁰⁹ Enhanced holding company obligations may be a useful way to redress the inequities resulting from the skewed incentives of subsidiary managers to do the bidding of their holding company shareholders to the exclusion of all other fiduciary duties owed.

The problem that subsidiary management faces is an example of what Professor Lawrence Mitchell calls a "horizontal conflict," that is, a conflict in which the board has competing duties to different corporate constituencies.²¹⁰ Horizontal conflicts are those situations where directors owe duties to more than one constituency and are charged with making sure that all the constituencies get their due, even though the interests of the shareholder tend to dominate the decisionmaking process.²¹¹ Horizontal conflicts arise frequently in corporate govern-

AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY 203-04, 268-69 (1995) (arguing that corporations should be seen as an institutional relationship among many constituencies including shareholders, employees, suppliers, and customers, and that the goal of the corporation should be to maximize wealth created by the enterprise, not just to maximize shareholder wealth).

209. Banks and bank directors owe duties to such nonshareholders as customers, *see* *Hoehn v. Crews*, 144 F.2d 665, 672 (10th Cir. 1944); *Commercial Cotton Co. v. United Cal. Bank*, 209 Cal. Rptr. 551, 554 (Ct. App. 1985) (finding that "[t]he relationship of bank to depositor is at least a quasi-fiduciary"); beneficiaries of trusts for which the bank served as trustee, *see* *Fiduciary Activities of National Banks*, 12 C.F.R. § 9.2 (1998); and, in some cases, borrowers, *see* *Bartlett v. Bank of Am.*, 229 Cal. Rptr. 16, 20-21 (Ct. App. 1986); *Barnett Bank v. Hooper*, 498 So. 2d 923, 925 (Fla. 1986). In addition, directors may find themselves the targets of lawsuits instituted by nonshareholder constituents involved in the corporate enterprise, including cease-and-desist proceedings by banking regulators, *see* 12 U.S.C. § 1818(b) (1994) (permanent orders); § 1818(c) (Supp. II 1994) (temporary orders); civil money penalties, § 1818(i)(2); removal or suspension, § 1818(e); and for gross negligence, § 1821(k), as well as by other parties, *see* *FDIC v. Boone*, 361 F. Supp. 133, 165 (W.D. Okla. 1972) (finding that directors may be subject to suit from the insurance company that bonds the bank if they act in an illegal, fraudulent, or negligent manner). *See generally* Norma Hildenbrand, *D&O Liability: Expansion Via Regulation*, 111 *BANKING L.J.* 365 (1994) (examining federal statutory initiatives to broaden the liability of bank officers and directors).

210. *See* Mitchell, *supra* note 31, at 603-07.

These conflicts between virtually omnipotent managers and relatively powerless constituents of the corporation (or the corporation itself) can be described as "vertical conflicts of interest," since they exist between a powerful group and relatively powerless groups within the hierarchical corporate structure. . . . The exception to this unitary approach is the recent focus on conflicts *among* constituents, which has been sharpened by the dislocations caused by the takeover phenomenon. I term these conflicts, which exist among two or more relatively powerless groups that have interests in the corporation, "horizontal conflicts."

Id. at 591.

211. *See id.* As Professor Mitchell has pointed out, the law has developed several methods to protect the corporation against director self-dealing, which Professor Mitchell refers to as a "vertical conflict." *See id.* For example, derivative suits are useful mechanisms to keep vertical conflicts in check because they allow shareholders to initiate an action to compel the directors to bring a legal action on behalf of the corporation and in some situations permit shareholders to prosecute the action without the involvement of the directors. *See* 1 WILLIAM MEADE FLETCHER ET AL., *FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 5941.10 (perm. ed. rev. vol. 1995). There are, however, few mechanisms in place to ensure that directors properly discharge their duties to nonshareholder constituencies in the horizontal conflict situation.

ance.²¹² For example, in corporations with more than one class of stock, directors sometimes make decisions that benefit one class more than another class, even though the directors owe a fiduciary duty to all of the shareholders.²¹³ Traditional corporate law has not satisfactorily addressed these horizontal conflict situations.²¹⁴ The incidence of horizontal conflicts multiplies when considering the duties that directors may owe to constituents other than the shareholders.²¹⁵

Although the directors may owe a duty to several different constituencies, ordinarily the only group with standing to hold the directors accountable is the shareholders.²¹⁶ The directors therefore tend to maximize shareholder interests to the exclusion of all others. Directors of wholly owned subsidiaries would seem to feel the pressure from shareholder wealth maximization a bit more keenly than the typical corporate director. Unlike the directors of a publicly traded corporation whose shareholders may be widely scattered, poorly organized, and more likely to sell their stock than to bring a derivative suit, the directors of the wholly owned subsidiary have their one and only shareholder looking over their shoulders on a regular basis. The

212. Horizontal conflicts arise as a result of the interplay of several threads of corporate law. The corporate law makes clear that directors are supposed to act in the best interests of the corporation, *see* Gouvin, *supra* note 32, at 298, *supra* notes 38-54 and accompanying text, and that the corporation consists of more than just the sum of its shareholders. *See* Gouvin, *supra* note 32, at 293; *supra* notes 54, 62-63 and accompanying text. At the same time, however, to remedy problems involving self-dealing, the law gives only shareholders standing to sue directors derivatively for breaches of duty to the corporation. *See* ALI PRINCIPLES OF CORPORATE GOVERNANCE § 7.02 (proposed final draft, 1992) (authorizing holders of "equity securities" (including securities convertible into equity), and in some cases directors, to commence and maintain derivative actions). Traditionally, convertible security holders were denied standing. *See* Kusner v. First Penn. Corp., 395 F. Supp. 276, 283-84 (E.D. Pa. 1975). *But see* Hoff v. Sprayregan, 52 F.R.D. 243, 247 (S.D.N.Y. 1971). Mere creditors have traditionally fared even worse than convertible security holders. *See* Habermas v. Washington Pub. Power Supply Sys., 744 P.2d 1032, 1061 (Wash. 1987) (finding that bondholders have no standing to sue derivatively).

213. *See* Lawrence E. Mitchell, *The Puzzling Paradox of Preferred Stock (And Why We Should Care About It)*, 51 BUS. LAW. 443, 445-51 (1996) (describing the conflict between various classes of equity holders).

214. *See id.* at 464-70.

215. In addition to the duties that all directors owe to the corporation and to other constituencies such as creditors, *see generally* Gouvin, *supra* note 32, at 297-300, 307-15, in the banking situation directors may owe additional fiduciary duties to depositors. *See* Hoehn v. Crews, 144 F.2d 665 (10th Cir. 1944); *Commercial Cotton Co. v. United Cal. Bank*, 209 Cal. Rptr. 551, 554 (Ct. App. 1985) (finding that bank has "at least [a] quasi-fiduciary" relationship with depositors); to beneficiaries of trusts for which the bank served as trustee, *see* 12 C.F.R. § 9 (1994); and, in some cases, to borrowers, *see* Barrett v. Bank of Am., 229 Cal. Rptr. 16, 20-21 (Cal. 1986); *Barnett Bank v. Hooper*, 498 So. 2d 923, 925 (Fla. 1986). For a discussion of those situations where a bank might be considered to have a fiduciary relationship with its customer, *see* Niels B. Schaumann, *The Lender as Unconventional Fiduciary*, 23 SETON HALL L. REV. 21, 40-43 (1992).

216. *See, e.g.,* Tierman v. Barresi, 944 F. Supp. 35, 37 (D. Me. 1996) (holding that non-shareholder has no standing to sue directors for breach of fiduciary duty). The directors understand well that the shareholders are the only group that can sue the board on behalf of the corporation. They understand that corporate control ultimately rests with the shareholders, who have the power to vote different directors into office. The result of the director-shareholder feedback loop is to focus director attention on shareholder interests to the exclusion of other interests. *See* Mitchell, *supra* note 31, at 605-06. *But see supra* note 209 and cases cited therein (evidencing duties owed to nonshareholders).

subsidiary's directors are subject to the control of the holding company, often because they are high-ranking employees of the holding company.²¹⁷ In light of the dominant role played by the shareholder in the subsidiary's operation, it seems disingenuous to pretend that the subsidiary's directors can ever act truly independently of the wishes of the parent.²¹⁸ The directors will rarely be able to fairly carry out their duties in the horizontal conflict situation, nor will they be able to discharge their duty to some other constituency if such a duty is found to be owing.

This situation leaves nonshareholders essentially without remedy in most situations. The problem of unresolved horizontal conflicts in the parent-subsidiary context is an especially pressing problem in the banking industry, where the vast majority of banks are wholly owned subsidiaries of bank holding companies.²¹⁹ In the banking context, this means that if directors have been taking action in violation of their duty to act in the best interests of the bank as a bank, there is no effective policing method to put the directors in line. As a result, lawsuits to hold the directors accountable for failing to act in the best interest of the bank as a bank must wait until the bank fails and the receiver steps in to marshal the assets of the failed institution, including any causes of action it may have had against its management.²²⁰ The mismatch between the duty owed to all the constituents of the bank and the enforcement mechanism that allows only shareholders to bring derivative actions causes nonshareholder constituents to bear more than their share of the costs of director action. In effect, the mismatch produces negative economic externalities that are borne by the nonshareholder constituents, including depositors, borrowers, employees, and the deposit insurance fund.²²¹

217. See EISENBERG, *supra* note 119, at 299-300.

218. The awkward position that "inside" directors of subsidiaries face does not give rise to a special rule for their fiduciary duties under traditional corporate law. The ABA Committee on Corporate Laws has clearly stated that the duties of affiliated and unaffiliated directors are the same. See Committee on Corporate Laws, *supra* note 106, at 213. Nevertheless, the Committee also recognized that "while both affiliated and unaffiliated directors have the same duty to the controlled corporation, the affiliated directors cannot be expected to be wholly detached from the special objectives of the controlling shareholder." *Id.* at 212.

219. In 1988, a total of 6503 bank holding companies controlled 9322 domestic commercial banks, representing 84.6% of the total number of banks and 90.2% of the bank deposits in the country. See Steven B. Long, Note, *AMBAC: The Substantial Question Doctrine Under the Bank Holding Company Act*, 79 GEO. L.J. 507, 507 n.1 (1991) (citing CONFERENCE OF STATE BANK SUPERVISORS, A PROFILE OF STATE CHARTERED BANKING 221 (1988)). In light of the tremendous industry consolidation since the release of these figures, the percentage has likely increased.

220. See, e.g., *Resolution Trust Corp. v. Walde*, 18 F.3d 943, 944 (D.C. Cir. 1994). For a general discussion of suits by regulators based on claims against directors, see James T. Pitts et al., *FDIC/RTC Suits Against Bank and Thrift Officers and Directors—Why Now, What's Left?*, 63 FORDHAM L. REV. 2087, 2094-2102 (1995).

221. See Mitchell, *supra* note 31, at 606; see also Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989

It stands to reason that because nonshareholder constituents of the bank have no effective method for holding directors accountable when directors fail to discharge their duties appropriately, their interests tend to be protected only when they coincide with the interests of the shareholders.²²² In the banking context, that means if the bank directors should take action that is in the best interests of the bank as a bank, they will only do so if that action coincidentally is the action that is in the best interest of the shareholder, the holding company.

Consequently, much of the impetus behind the market discipline hypothesis as a justification for enhanced holding company liability is the realization that the most effective way to make bank management behave in a way that maximizes the benefit to the bank as a bank is to make the holding company's self-interest congruent with acting in the best interest of the bank as an entity. Certainly a big step in that direction was accomplished through the imposition of mandatory capital requirements. By making holding companies put a significant amount of equity capital at risk in their banking subsidiaries, the banking regulators believed, correctly, that the holding companies would be more attentive to bank manager risk taking.²²³ Yet the regulatory scheme goes far beyond capital requirements. Even after the significant capital investment has been wiped out, the holding company may still be liable.

That portion of the regulatory arsenal seeking to impose costs on holding companies above and beyond the capital invested can be explained at least partially by the implicit assumption that the holding company should be made to suffer the costs of bank failure because it profited during the good times and because of the suspicion that the bank holding company was somehow responsible for the bank's failure. Yet regulations presumptively casting the holding company as the villain may be off the mark.²²⁴ Certainly some holding company-owned banks fail due to macroeconomic conditions without any contributing fault from poor managers or overreaching holding companies. In fact, the Congressional Budget Office estimated that thirty-five percent of the banks that failed in the banking crisis of the late

DUKE L.J. 173, 182 n.34 (1989) (implicitly acknowledging the existence of externalities in this situation).

222. Lucian Bebchuk has argued that economically efficient statutes would take into account the interests of shareholders and nonshareholders alike, but the interstate competition for corporate charters results in the development of statutes that appeal to the people who choose where to incorporate, and those people will choose laws that maximize shareholder value. See Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on the State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1485 (1992).

223. See U.S. TREASURY DEP'T, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS 12 (1991) (expressing the view that increased capital is the "single most powerful tool to make banks safer" and that "banks are less likely to take excessive risk when they have substantial amounts of their own money at stake").

224. See *supra* notes 88-90 and accompanying text (discussing the lack of empirical evidence for the hungry wolf hypothesis).

1980s did so for macroeconomic reasons.²²⁵ If a bank fails under those conditions without any foul play by the holding company, why should the banking regulators be permitted to recover anything from the bank holding company? Nevertheless, under the current regulatory scheme, the holding company has to contend with the source of strength doctrine and other enhanced obligations regardless of the fact that the holding company did not cause the failure and perhaps could have done little to prevent it.

To find the right balance between respecting the separate legal entities of the bank and its holding company on the one hand, and imposing liability directly on the holding company on the other, regulators need to take a more realistic view of the horizontal conflict problem. In light of the fact that the parent entirely controls the subsidiary's management,²²⁶ it is unrealistic to expect the directors of subsidiaries to act in an independent manner in the best interests of the subsidiary corporation even though such action would be required in the ordinary situation for corporate directors.²²⁷ Instead of imposing an unrealistic standard that would require subsidiary directors to behave as if they were truly independent, regulators should be more pragmatic and require them only to discharge their duty to act in the best interest of the parent-shareholder.²²⁸

Because the subsidiary directors are not free to act independently, it is unfair to expect them to meet larger obligations to non-shareholder constituents. Given this reality, the law should treat subsidiary directors in accordance with their true status—as agents of the parent—and impose on them only the duty to act in the parent's best interests.²²⁹ In turn, the duties that directors of subsidiary corporations ordinarily would have been charged with had they been truly independent should be imposed directly on the parent corporation. By adopting this approach to the horizontal conflict problem, enterprise principles could supplement traditional entity law. Regulators could continue to recognize the legal separateness of subsidiaries, while supplementing that idea with the understanding that as part of a corpo-

225. See CBO STUDY, *supra* note 100, at 20 (reporting on a study by the Office of the Comptroller of Currency that 35% of the banks that failed between 1987 and 1992 did so due to "external economic conditions" such as inflation, recession, competition, and interest rate volatility).

226. See EISENBERG, *supra* note 119, at 299-300.

227. See Gouvin, *supra* note 32, at 297-300.

228. To do so would require a special rule of corporate law, however, because while placing shareholder interests first is appropriate in some contexts, it is not the usual director duty. See *id.* at 300-02.

229. This is the position taken by the Delaware Supreme Court in *Anadarko Petroleum Corp. v. Panhandle E. Corp.*, 545 A.2d 1171, 1174 (Del. 1988), and adopted as black-letter law in 3 BETH A. BUDAY & GAIL A. O'GRADNEY, *FLETCHER CYCLOPEDIA OF CORPORATIONS* § 844.30 (1994), although it only cites *Anadarko Petroleum* for support.

rate group the duties of the directors should be passed on to the parent corporation.²³⁰

The law of agency provides the basis for transferring those duties.²³¹ The directors of the subsidiary are essentially agents of the parent corporation and because they are acting on the parent's behalf and subject to the parent's control, the relationship of principal and agent ought to apply. Although ordinarily directors of corporations are not considered to be agents of the shareholders,²³² in the wholly owned subsidiary situation there ought to be a special rule. In the usual corporation the shareholders may be too dispersed to be acting as a "principal" that could manifest consent to and exercise control over the directors as "agents," but in the wholly owned subsidiary situation, the identity of the shareholder is well known, and, of course, the solitary shareholder is capable of expressing consent and exercising control. Also in the usual corporation, key shareholders who are natural persons would sit on the board of directors themselves, but where the principal shareholder is not a natural person, the only way it can have representation on the board of its controlled corporation is through its agents.

Another confounding factor in the traditional agency scheme ordinarily preventing directors from being considered agents of the shareholders is that the directors of a corporation are elected to make decisions for the corporation, not for the shareholders. Shareholders do not play an active role in the management of the corporation. They are empowered to vote for directors and to vote on fundamental matters, but otherwise they do not have a role to play. Therefore, ordinarily, there is not much that a person could do as an agent of the shareholders because the shareholders themselves have little to do, and the agent cannot have greater authority than his principal. In the case of the wholly owned subsidiary, however, the role of the shareholder-holding company is different from the role of the traditional

230. This is an idea that Professor Blumberg has considered in the context of liability for subsidiaries, although I am focusing here on the liabilities of the subsidiary directors as agents of the parent. See Blumberg, *supra* note 117, at 321-29.

231. It is perhaps more appropriate to talk about the directors of the subsidiary as "quasi agents" rather than as true agents, because the traditional requirements for the agency are not always present. See RESTATEMENT (SECOND) OF AGENCY § 1 (1958) (defining agency as the "fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act.").

232. See *id.* § 14C cmt. b (noting that directors are not agents because they are not subject to control and because the duty owed by a director runs to the corporation and not to the shareholders); see also MODEL BUS. CORP. ACT ANNOTATED 784-85 (3d ed. 1984), reprinted in ROBERT W. HAMILTON, CORPORATIONS, at 404-05 (6th ed. 1998) (noting that agency theory of corporate directors has been "generally rejected"). Nevertheless, directors sometimes do act like agents of the shareholders, and the law ought to recognize that phenomenon. For a discussion of the quasi-agency application in the enterprise liability context see BLUMBERG, PROCEDURAL, *supra* note 116, §§ 1.02.2, 4.02.1, 4.04.1, and BLUMBERG, SUBSTANTIVE COMMON LAW, *supra* note 116, §§ 6.06, 14.03.3. The idea of "quasi agency" may be developed more clearly in the pending revision to the *Restatement of Agency*.

shareholder of a widely held unaffiliated corporation. In the real world, a wholly owned subsidiary serves a role almost indistinguishable from the role played by a traditional corporate division; therefore, it seems anomalous that corporate law should treat two functionally very similar arrangements with widely disparate rules.²³³

The idea of using agency (or agency-like) principles to hold shareholders liable has been around for a long time²³⁴ and shows up in modern cases as well.²³⁵ Extending the agency idea to impose liability on holding companies for duties that the subsidiary directors failed to carry out nevertheless raises some awkward questions. Perhaps the most pressing question raised by the quasi-agency approach is why the consequences of agency should attach to one but not all of the dimensions of the subsidiary director's position. In other words, if the subsidiary's directors act as agents on behalf of the parent corporation, why would such an understanding of the parent-subsidary-director relationship not give rise to liability for the parent as principal for all obligations incurred formally by or on behalf of the subsidiary through the directors?

The answer to this question also lies in agency. The scope of the agency would not include the authority to incur liability for the parent as a general agent; instead the subsidiary directors' agency would be limited to the role of performing the tasks ordinarily associated with acting as directors of a subsidiary. To see how this would work, it may be useful to examine the authority of the subsidiary directors as if they were traditional agents. First, as above, one could argue that the directors in this special situation are agents, even though directors of corporations generally are not so considered. If these subsidiary directors are agents, one must ask, agents for what purpose? That is, what authority do these agents have? Under the Restatement, authority comes in three types: actual, apparent, and inherent.²³⁶

For an agent to have authority, there must be a manifestation of consent from the principal that the agent can reasonably interpret as creating authority to act.²³⁷ In the case of subsidiary directors, the agents have received express actual authority from the principal hold-

233. See EISENBERG, *supra* note 119, at 303.

234. See *Berkey v. Third Ave. Ry. Co.*, 155 N.E. 58, 61 (N.Y. 1926) ("Dominion may be so complete, interference so obtrusive, that by the general rules of agency the parent will be a principal and the subsidiary an agent. Where control is less than this, we are remitted to the tests of honesty and justice."); *Ervin v. Oregon Ry. & Nav. Co.*, 27 F. 625, 631 (S.D.N.Y. 1886) (essentially impressing the majority shareholders with the fiduciary duties of the directors).

235. See, e.g., *Royal Indus. Ltd. v. Kraft Foods, Inc.*, 926 F. Supp. 407, 413 (S.D.N.Y. 1996) (explaining that liability of a parent corporation should depend on whether the subsidiary was an agent for the parent and acting with actual or apparent authority); *National Council on Compensation Ins. v. Hopkins*, No. 1192-CV-082, 1995 U.S. Dist. LEXIS 21030, at *46 (E.D. Tenn. Dec. 19, 1995) (allowing RICO to impose liability on a corporate "person" for acts of its agents, including its corporate agents).

236. See RESTATEMENT (SECOND) OF AGENCY § 140 (1958).

237. See *id.* § 26.

ing company to serve the principal by running the subsidiary. In a sense, the relationship is similar to the proxy given by a shareholder to a proxy holder—a direction to attend the shareholders meeting and take the actions that a shareholder can take. In the subsidiary situation, however, the principal appoints “proxies” to serve in the role of director and to take the actions that directors take. Of course the holding company shareholder must resort to this device because, unlike individual shareholders, the corporate shareholder itself cannot serve as a director—it needs natural persons to serve in that capacity. Appointment to the position of director of a subsidiary corporation could be reasonably interpreted by the agent directors as giving them the authority to act on the parent’s behalf and in the parent’s interest in running the corporate enterprise. Not everything the board of directors does would be authorized—only those things done within the confines of the management of the corporate enterprise.

How would this agency affect third parties who deal with the subsidiary directors—would they have claims against the parent as well based on the “agency” of the directors? They would not have liability if the authority argument is based solely on principles of actual authority. The directors have been authorized to run the subsidiary—not to make direct obligations on the parent’s behalf. This could be easily manipulated, however, with parents never admitting “actual” authority to bind the parent even in egregious situations where the parent should be liable on agency principles. In that situation a third party could turn to the concept of apparent authority.²³⁸

To find that an agent has apparent authority, the inquiry turns to whether the principal made manifestations of consent that *a third person* could reasonably interpret as giving the purported agent the authority to act.²³⁹ In the ordinary situation, however, assuming the subsidiary corporation is a respectable corporation in every other respect—i.e., is well capitalized, is run as a separate business, observes corporate formalities, etc.—the actions of the directors do not create liability for the shareholders. Third parties know or should know that; therefore, it would not be a reasonable interpretation of the subsidiary director’s position as creating the apparent authority to bind the shareholder of the subsidiary corporation. To allow third parties recovery in that situation would be a windfall, because it should be assumed that they knew they were dealing with a corporation, albeit a subsidiary, and that ordinarily the liability of a corporation is not the liability of its shareholders.²⁴⁰ The legal form of the parties are impor-

238. *See id.* § 8.

239. *See id.* § 27.

240. In the view of the so-called contractarian theory of corporate law, the law in its many details spells out an elaborate contract between the affected parties. *See generally* EASTERBROOK & FISCHEL, *supra* note 166, at 1-39; Henry N. Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON L. REV. 99, 120-22 (1989). For a critique of the contractual theory,

tant aspects of the deal, and the law ought to respect the provisions of the contract that the parties have invoked.²⁴¹

Finally, it could be argued that directors of subsidiaries bind their principal through the concept of "inherent" authority. Inherent authority is hard to pin down but seems to flow from the idea in section 8A of the *Restatement* that one of the three ways an agent can bind her principal is solely by virtue of the "agency relation."²⁴² Professor Melvin Eisenberg has proposed a workable test for inherent authority in which the acts of the agent are evaluated as reasonably foreseeable from the principal's point of view.²⁴³ In the case of subsidiary directors, this test would be unlikely to give rise to liability for the principal because in the typical situation it is not reasonably foreseeable that the actions of the directors of a controlled corporation will create liability for the shareholder. Therefore, without adoption of the horizontal conflicts-agency approach, ordinary principles of agency law do not create liability for the parent corporation for ordinary corporate acts.

Another question deserving attention is why, if the subsidiary is presumed to be so thoroughly dominated by the holding company, the subsidiary itself is not an agent of the parent, therefore logically requiring imposition of liability on the parent for all of the subsidiary's obligations. This is a more difficult question, and it may turn out that in some circumstances the domination and control that the parent exerts over the subsidiary are so complete that we ought to consider the subsidiary merely an agent of the parent.²⁴⁴ On the other hand, most subsidiaries are probably not dominated to that extent.²⁴⁵ Even in these subsidiaries, however, it is difficult for directors to act independently of the parent, and the law should recognize that fact.

The proposed agency approach to subsidiary director duties rehabilitates an otherwise properly functioning corporate entity that suffers from the deficiency of not discharging duties to its nonshareholder constituents. The closest existing analogies are those cases where courts impose the fiduciary duties of subsidiary directors directly on majority shareholders, especially in the cases involving problems of "fair dealing" with minority shareholders of the subsidi-

see William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407 *passim* (1989).

241. See *Bagdon v. Bridgestone/Firestone, Inc.*, 916 F.2d 379, 383-84 (7th Cir. 1990) (voicing Judge Easterbrook's opinion that partnerships and corporations should be separate legal forms, the choice between which involves "many formalities" but which once selected should give rise to predictable legal consequences).

242. See RESTATEMENT (SECOND) OF AGENCY § 8A (1958).

243. See MELVIN A. EISENBERG, AN INTRODUCTION TO AGENCY AND PARTNERSHIP 15-16 (2d ed. 1995).

244. See BLUMBERG, SUBSTANTIVE COMMON LAW, *supra* note 116, § 6.06.

245. The actual conduct of specific directors in specific situations may vary even within the same corporate family. See *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1119-20 (1991) (Kennedy, J., concurring in part and dissenting in part) (describing markedly different reactions of two similarly situated subsidiaries to the same parent actor).

ary.²⁴⁶ An agency approach to the resolution of the horizontal conflict problem would really amount to nothing more than an expansion of the cases dealing with the duties of controlling shareholders, such as *Sinclair Oil Corp. v. Levien*,²⁴⁷ *Wright v. Heizer Corp.*,²⁴⁸ and *Chiles v. Robertson*.²⁴⁹ In *Chiles*, for instance, the directors of a group of subsidiaries failed to discharge their fiduciary duty to the minority shareholder of the subsidiaries. The court properly imposed the duty of the subsidiary's directors directly on the controlling shareholder.²⁵⁰

In *Sinclair*, the Delaware Supreme Court expressly recognized that "[a] parent does indeed owe a fiduciary duty to its subsidiary when there are parent-subsidary dealings."²⁵¹ The decision explicitly noted that when a shareholder dominates a corporation and the selection of the corporation's board of directors, the dominating shareholder should be charged with the duties ordinarily imposed on the directors.²⁵² In that vein, *Sinclair* evaluated the parent's liability for certain parent-subsidary transactions in light of the same standards that would have applied to independent directors in the same position. *Sinclair*'s reasoning provides a logical and compelling rationale for imposing all the duties of a subsidiary's directors (other than the duty to act in the best interest of the shareholder) directly on the parent—whether those duties run to minority shareholders, creditors, stakeholders, or regulators.

Similarly, in *Wright v. Heizer Corp.* the majority shareholder who controlled the board of directors caused the board to enter into a pledge of the controlled corporation's assets to the controlling shareholder on terms that were unfair to the controlled corporation.²⁵³ In a derivative action by a minority shareholder, the controlling shareholder was found liable.²⁵⁴ Cases where the controlling shareholder

246. See, e.g., *Burton v. Exxon Corp.*, 583 F. Supp. 405, 414-15 (S.D.N.Y. 1984) (recognizing that parent corporations owe the minority shareholders of their subsidiary corporations a fiduciary duty and that the directors of the subsidiary placed there by the parent may be subject to the "intrinsic fairness" test to review self-dealing transactions in which the parent gets a benefit to the exclusion of the minority shareholder); *Weinberger v. UOP Inc.*, 457 A.2d 701, 703 (Del. Super. Ct. 1983) (stating that the majority shareholder bore the burden of proving by a preponderance of the evidence that the cash-out merger was fair); accord *Jones v. H.F. Ahmanson & Co.*, 460 P.2d 464, 471 (Cal. 1969) ("Majority shareholders may not use their power to control corporate activities to benefit themselves alone or in a manner detrimental to the minority."); *Citron v. E.I. DuPont de Nemours & Co.*, 584 A.2d 490, 500 (Del. Ch. 1990); see also John C. Carter, *The Fiduciary Rights of Shareholders*, 29 WM. & MARY L. REV. 823, 841-42 (1988).

247. 280 A.2d 717 (Del. 1971).

248. 560 F.2d 236 (7th Cir. 1977).

249. 767 P.2d 903 (Or. Ct. App. 1989).

250. See *id.* at 911.

251. *Sinclair*, 280 A.2d at 720; accord *Getty Oil Co. v. Skelly Oil Co.*, 267 A.2d 883, 888 (Del. Super. Ct. 1970). But see *In re New York Ry. Corp.*, 82 F.2d 739, 741 (1936) (stating that where the controlling shareholder did not also control the board of directors, "there is no basis for the contention that the [controlling shareholder] was in any fiduciary relationship").

252. See *Sinclair*, 280 A.2d at 719.

253. See *Wright*, 560 F.2d at 251.

254. See *id.*

engages in overreaching at the expense of minority shareholders generally end with the parent corporation owing a duty to the minority shareholders of the subsidiary. A logical extension of that doctrine would require the parent to take on the duties that the subsidiary directors would have owed to any other constituencies as well.²⁵⁵

One case taking this approach is *Pioneer Annuity Life Insurance Co. v. National Equity Life Insurance Co.*²⁵⁶ It is an example of the type of holding company liability that a quasi-agency approach would require. *Pioneer Annuity* involved an insurance holding company that allegedly had systematically looted its subsidiary insurance company. When both parent and subsidiary ended up in receivership after the parent's misapplication of reinsurance premiums, the receiver of the subsidiary sued to impress a constructive trust on the reinsurance premiums paid by the subsidiary to the parent.²⁵⁷ A judge on the Arizona Court of Appeals adopted the position that the parent corporation owed its subsidiary and "its cognizable communities of interest a fiduciary duty to act fairly."²⁵⁸ In overturning a grant of summary judgment in favor of the parent, the Court of Appeals recognized that the fiduciary duty borne by the parent was owed to, among others, "policyholders and contract-holders" of the subsidiary.²⁵⁹

The *Pioneer Annuity* court did not employ agency principles explicitly to impose the fiduciary duties of the corporation on the majority shareholder. It offered no explicit legal theory to justify the action. The opinion cited two prior Arizona cases as support for the proposition that a majority shareholder owes a duty to the minority, but neither of those cases goes into any detail about why, as a matter of legal theory, that duty exists.²⁶⁰ More surprising, to the extent that the two cases are offered for support for the idea that a majority shareholder owes a duty not just to the minority but also to the "cognizable communities of interest" of the corporation, the cited cases are obscure at best. In *Washington National Trust*, the cited page lends support to the idea that a majority shareholder cannot appropriate to himself corporate assets "to the detriment of *other stockholders*."²⁶¹ Nothing in *Washington National Trust* can be fairly read to give rise to a duty to the cognizable communities of interest of *Pioneer Annuity Life*. In *Steinfeld*, however, the court states that "[t]he holder of the majority of the stock in a corporation owes to the other stockholders and *the corporation* the duty to exercise good faith, care and diligence,

255. See *supra* notes 91-139 and accompanying text.

256. 765 P.2d 550 (Ariz. Ct. App. 1988).

257. See *id.* at 553.

258. *Id.* at 555.

259. *Id.*

260. The cited cases are *Washington National Trust Co. v. W.M. Dary Co.*, 568 P.2d 1069 (Ariz. 1977), and *Steinfeld v. Copper States Mining Co.*, 290 P. 155 (Ariz. 1930).

261. 568 P.2d at 1072 (emphasis added).

to conserve the property of the corporation, and to protect the interests of minority stockholders."²⁶²

Reading the word "corporation" broadly to include something other than just the sum of the shareholders, *Steinfeld* offers support for *Pioneer Annuity* consistent with an expansive understanding of the corporate enterprise. Indeed, the *Pioneer Annuity* court cites the famous case, *Pepper v. Litton*,²⁶³ in the very next paragraph after the statement about a duty to the cognizable communities of interest. In *Pepper*, Justice Douglas stated that a director's fiduciary duty is "designed for the protection of the *entire community of interests in the corporation*."²⁶⁴ Although *Pepper* concerned the existence of a fiduciary duty to creditors, when read broadly the case establishes the principle that directors are not free to take action designed to maximize shareholder benefit if that action will be inequitable to the other constituents who have a connection to the corporation.

The idea that director duties in the insolvency situation extend beyond the interests of the shareholders as articulated in *Pepper* finds support in other case law. For instance, cases have held that directors must manage an insolvent corporation's assets with attention to the interests of creditors.²⁶⁵ Although the duty to consider the interests of creditors is not unbounded and the courts have grappled with applying such a duty in specific contexts,²⁶⁶ the idea of a duty to creditors has been extended to corporations merely in the "vicinity of insolvency" as well as those actually insolvent.²⁶⁷

The central idea of *Pioneer Annuity* easily applies to the bank holding company situation. Bank directors should be impressed with a duty to act fairly with respect to the community of interests that

262. 290 P. at 160 (emphasis added).

263. 308 U.S. 295 (1939).

264. 308 U.S. at 307 (emphasis added).

265. See, e.g., *In re STN Enter.*, 779 F.2d 901, 904 (2d Cir. 1985) (finding that the directors of an insolvent corporation owe a fiduciary duty to creditors); *New York Credit Men's Adjustment Bureau, Inc. v. Weiss*, 110 N.E.2d 397, 398 (N.Y. 1953) (finding an obligation to protect property for creditors when corporation is insolvent or approaching insolvency).

266. For example, it appears that the duty to creditors does not exist in the normal operation of the corporation. See, e.g., *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1524-25 (S.D.N.Y. 1989) (refusing to impose fiduciary duty of corporate directors in a case not involving insolvency or fraud); *Simons v. Cogan*, 549 A.2d 300, 302-04 (Del. 1988) (finding that directors owe no fiduciary duty to convertible debenture holders); *Harff v. Kerkorian*, 324 A.2d 215, 222 (Del. Ch. 1974), *rev'd on other grounds*, 347 A.2d 133, 133-34 (Del. 1975) (finding that directors owe fiduciary duty to debenture holders only in "special circumstances" including insolvency, fraud, or illegality). *But see Allied Indus. Int'l v. Agfa-Gevaert, Inc.*, 688 F. Supp. 1516, 1521 (S.D. Fla. 1988) (concluding that directors do owe a duty to creditors of the corporation). For a general discussion, see William W. Bratton, Jr., *The Economics and Jurisprudence of Corporate Bonds*, 1984 WIS. L. REV. 667; Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413 (1986); Morey W. McDaniel, *Bondholders and Stockholders*, 1988 J. CORP. L. 205.

267. See *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 784 (Del. Ch. 1992); *Credit Lyonnais Bank Nederland v. Pathe Communications Corp.*, No. 12150, 1991 Del. Ch. LEXIS 215, at *1, 100-03 (Del. Ch. Dec. 30, 1991).

makes up the bank—including such constituents as the depositors, borrowers, employees, and even the deposit insurance fund. If the directors fail to discharge those duties, the holding company should be held liable for the harm caused thereby.

The benefit of the horizontal conflict approach is that it does not leave bank directors in constant fear of being second-guessed by regulators or other litigants in the daily conduct of the banking business. The regulatory scheme should take special pains not to create disincentives to appropriate risk taking. The current scheme of holding company obligations, designed as they are to force holding companies to impose market discipline on bank directors, may result in excessive monitoring of bank management, which may produce negative consequences.²⁶⁸ Bank managers may react by exercising too much caution, preferring to invest bank funds in, for example, government securities instead of extending credit to small businesses in the community.²⁶⁹ On credit that they do extend, an oversensitivity to risk may result in higher pricing, overly conservative asset valuations, and higher loan loss reserves, which in turn could lead to a self-fulfilling prophecy of closer regulatory scrutiny, examiner-ordered write downs, and ultimately, a diminution in stock value long before the underlying credits warrant such actions.²⁷⁰

Of course, the problem remains of how the affected non-shareholder constituents may recover from the holding company for the directors' failure to discharge their duties to them. Heavily regulated industries like banking provide probably the easiest case for this kind of recovery. The receivers of failed financial institutions have consistently pursued the most promising avenue—suits on behalf of the failed institution for failure to act in the best interests of the bank as a bank.²⁷¹ Because the classic formulation of directors' duties is that

268. Some commentators suggest that bank managers are already too cautious. See Garten, *supra* note 91, at 192; cf. Bruce Chapman, *Corporate Tort Liability and the Problem of Overcompliance*, 69 S. CAL. L. REV. 1679, 1683-94 (1996) (discussing the problem of overcompliance or excessive caution among corporate employees faced with possible personal liability for corporate acts and arguing that such overcompliance is both economically inefficient and inappropriate as a matter of corrective justice).

269. See Utset, *supra* note 145, at 222 ("Managers, realizing that their investment in human capital will be lost completely if they lose their jobs, will pay close attention to regulators' signals, in some cases becoming much more cautious than the regulators intended."). But see McCoy, *supra* note 94, at 58-60 (reviewing historical cases of bank director liability and concluding that she could find "little empirical evidence of long-term, undue risk aversion," although she conceded the likelihood of short-term risk-aversion to director liability rules). Professor McCoy's study obviously was hampered by her reliance only on reported cases to glean her conclusions, and she could not assess the impact of rules on companies whose policies did not ultimately end in litigation. Given that there have historically been literally thousands of banks in the United States, it is somewhat suspect to conclude how the whole industry acted by extrapolating from the relatively few reported cases on the books. See *id.*

270. See Paul H. Irving & T. Hale Boggs, *Financial Institution Directors: Mitigating Risks of Liability in Shareholder Actions*, 109 BANKING L.J. 336, 349 (1992).

271. See *supra* note 220.

they owe a duty to "the corporation and its shareholders"²⁷² the receivers take advantage of the possibility that the directors have honored their duty to the shareholder at the expense of the duty to the corporation.

Other than the receivership context, however, it is difficult for nonshareholder constituents to vindicate their rights. At present, courts only recognize the rights of equityholders to bring derivative suits on behalf of the corporation.²⁷³ To the extent the directors' duty to the "corporation" means a duty to the community of interests that makes the corporate enterprise successful—i.e., its employees, customers, vendors, and even the communities in which they operate—those stakeholders are without a legally recognized voice in the courts. Courts could change this by finding standing where none has been found before, but it seems more likely that if real change is to be made in this area, it will have to be through legislation.

On this matter, Professor Lawrence Mitchell has argued that nonshareholder constituents should be given standing to challenge director action.²⁷⁴ In his scheme, an action taken by the directors that advances shareholder interests at the expense of the nonshareholder interests would have to pass a test similar to the one governing the relations between shareholders in closely held companies as articulated in *Wilkes v. Springside Nursing Home*.²⁷⁵ Specifically, the direc-

272. See Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) (stating that directors owe "fundamental fiduciary obligations to the corporation and its shareholders"); Guth v. Loft, 5 A.2d 503, 510 (Del. 1939) (stating that directors are fiduciaries of the corporation and its shareholders); Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 43 (Del. Super. Ct. 1993) ("[T]he directors owe fiduciary duties of care and loyalty to the corporation and its shareholders.") (quoting Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1280 (Del. Super. Ct. 1989)); Midwest Management Corp. v. Stephens, 353 N.W.2d 76, 80 (Iowa 1984) ("[D]uty is owed the corporation and its shareholders whenever the actions of the director concern 'matters affecting the general well being of the corporation.'"). This duty is sometimes imposed by statute. See, e.g., CAL. CORP. CODE § 309 (West 1990) (stating that the duty is to the best interest of the corporation and its shareholders); N.Y. BUS. CORP. LAW § 717 (McKinney 1986 & Supp. 1995) (stating that directors consider the long-term and short-term interests of the corporation and its shareholders); ME. REV. STAT. ANN. tit. 13-A, § 716 (West 1981 & Supp. 1998) ("The directors and officers of a corporation shall exercise their powers and discharge their duties in good faith with a view to the interests of the corporation and of the shareholders . . ."). But see CONN. GEN. STAT. ANN. § 33-756(a)(3) (West 1997) (stating that directors should consider the best interest of the corporation); MASS. ANN. LAWS ch.156B, § 65 (Law. Co-op. 1979 & Supp. 1998) (stating that directors should consider the best interest of the corporation); 15 PA. CONS. STAT. ANN. § 1712(a) (West 1994) (stating that directors "stand in a fiduciary relation to the corporation").

273. See ALI PRINCIPLES OF CORPORATE GOVERNANCE § 7.02 (proposed final draft, 1992) (authorizing holders of "equity securities" (which includes securities convertible into equity), and in some cases directors, to commence and maintain derivative actions). Traditionally, convertible security holders were denied standing. See Kusner v. First Pennsylvania Corp., 395 F. Supp. 276, 282-83 (E.D. Pa. 1975). But see Hoff v. Sprayregan, 52 F.R.D. 243, 247 (S.D.N.Y. 1971). Mere creditors have traditionally fared even worse than convertible security holders. See Habermas v. Washington Pub. Power Supply Sys., 744 P.2d 1032, 1061 (Wash. 1987) (stating that bondholders have no standing to sue derivatively).

274. See Mitchell, *supra* note 31, at 634-36.

275. 353 N.E.2d 657, 663 (Mass. 1976).

tors would have to support the challenged action by offering a legitimate business purpose that justifies the action. The non-shareholder constituents would then be permitted to show that the business purpose could have been achieved by a less harmful method.²⁷⁶

Professor Mitchell's approach could provide a workable approach to resolving some horizontal conflicts, especially when the conflict is between the shareholders on one hand and a relatively well-recognized nonshareholder constituency, such as creditors or the corporation itself, on the other. However, when the universe of possible constituent groups is made a little larger, to include employees, communities, and others, for instance, the resolution of the horizontal conflict will not work as well. Under current case law, directors may or may not be justified in taking nonshareholder interests into account in the corporate decisionmaking process, depending on the context in which the decisions are made.²⁷⁷ Even in states that have explicit "other constituency" statutes,²⁷⁸ only one, Connecticut, requires that the directors consider nonshareholders in making their decisions, and even then only for publicly traded corporations in specific situations.²⁷⁹ Professor Mitchell's proposal will inevitably run roughshod over the well-established deference corporate jurisprudence gives to directors to make business decisions under the business judgment rule. At the same time, it would give little guidance to corporate directors seeking to properly discharge their duties and could only serve to expose directors to another layer of potential lawsuits if an affected group disagrees with the board's decision.

In light of their current status in corporate law, nonshareholders may have to wait until courts adopt a more "communitarian" view of the corporation²⁸⁰ before they enjoy a meaningful mechanism to re-

276. See Mitchell, *supra* note 31, at 635-38.

277. See Gouvin, *supra* note 32, at 310-12.

278. At least 28 states have enacted other constituency statutes. For a tidy summary of these laws in tabular format, see Steven M.H. Wallman, *The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties*, 21 STETSON L. REV. 163, 194-96 (1991). Maine's corporate constituency statute is fairly typical of the permissive, but not mandatory, nature of these provisions. It states that "[i]n discharging their duties, the directors and officers may, in considering the best interests of the corporation and its shareholders, consider the effects of any action upon employees, suppliers, and customers of the corporation, communities in which offices or other establishments of the corporation are located and other pertinent factors." ME. REV. STAT. ANN. tit. 13-A, § 716 (West Supp. 1998).

279. Connecticut's "other constituency" provision appears to be unique in that it *requires* the board to take into consideration the "long term" interests of the corporation and its shareholders, the interests of employees, customers, creditors, and suppliers, and "community and societal considerations" when making decisions in connection with the merger or the sale of substantially all the assets of a publicly traded Connecticut corporation. See CONN. GEN. STAT. ANN. § 33-756(d) (West 1997).

280. For a general discussion of the communitarian idea, see William T. Allen, *Contracts and Communities in Corporation Law*, 50 WASH. & LEE L. REV. 1395, 1397-1401 (1993). See also David Millon, *Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373, 1391-93 (1993) (providing a bibliography of communitarian scholarship in the

cover from the holding company. In the meantime, however, even without taking the radical step of recognizing standing for such non-shareholder constituents as employees, communities, and customers, transferring the *recognized* nonshareholder duties (especially the duty to creditors and the duty to the corporation as an entity) from the subsidiary's board of directors to the holding company serves to make the duties of the subsidiary board easier to articulate and execute. If this position were to be adopted, the existing Delaware law that directors of wholly owned subsidiaries owe a duty only to the parent corporation²⁸¹ will be rationalized with those threads of corporate law that find duties to nonshareholders.

IV. EXAMINING OTHER APPROACHES

Several scholars have offered suggestions for improving the bank holding company liability scheme, but because all of those approaches rely on the traditional policy justifications discussed earlier in this article,²⁸² they fall short of achieving the right balance. The quasi-agency approach overcomes the shortcomings of the other approaches.

A. *Enhanced Holding Company Obligations Subject to a Limit*

Professor Howell Jackson has written quite persuasively that enhanced holding company obligations serve as an effective complement to traditional forms of regulation and help to ameliorate what he refers to as the "regulatory deterioration" problem by shifting a part of the regulatory burden (monitoring risky bank management actions)

corporate law field); David Millon, *State Takeover Laws: A Rebirth of Corporation Law?*, 45 WASH. & LEE L. REV. 903, 905 (1988) (heralding the emergence of an approach to corporate law that seeks to address important questions about the relationship between corporations and society).

281. See *Anadarko Petroleum Corp. v. Panhandle E. Corp.*, 545 A.2d 1171, 1174 (Del. 1988) (stating unequivocally that "in a parent and wholly-owned subsidiary context, the directors of the subsidiary are obligated only to manage the affairs of the subsidiary in the best interests of the parent and its shareholders"). The facts of *Anadarko* deserve some development. *Anadarko Petroleum Corp.* (*Anadarko*) was a wholly owned subsidiary of *Panhandle Eastern Corp.* (*Panhandle*). *Panhandle* and some of its other subsidiaries were engaged in the business of running natural gas pipelines. *Anadarko* was engaged in the business of developing and extracting oil. The board of *Panhandle* decided to divest itself of *Anadarko* by spinning off the subsidiary to the existing shareholders of *Panhandle*. After the spin-off, *Anadarko* shares would be listed on the New York Stock Exchange. In information distributed to its shareholders regarding this spin-off transaction, *Panhandle* indicated that it would continue to do business with *Anadarko* after the spin-off. Toward that end, prior to the spin-off, *Panhandle* and *Anadarko* renegotiated several intracorporate contracts that existed between them, with the result that the renegotiated contracts were much more favorable to *Panhandle* than they had been. After the spin-off, *Anadarko*'s new board of directors sued *Panhandle* to void the renegotiated contracts. See *id.* at 1173-74. The court did not impose a burden of showing "entire fairness" on *Panhandle*, however, because that duty would arise only if *Panhandle* and the original *Anadarko* board had held a fiduciary position with respect to the future stockholders of *Anadarko* and had engaged in self-dealing to the detriment of those shareholders. The court found no such duty. See *id.* at 1177.

282. See *supra* notes 44-145 and accompanying text (Part II).

onto holding companies,²⁸³ which, after all, have a much more thorough understanding of the business of banking than government regulators will ever have.²⁸⁴ He has proposed a scheme of enhanced holding company obligations that would apply to all financial holding companies in all situations and would supplant the existing melange of regulatory devices. Exactly what the enhanced obligation would be is not clear, but Professor Jackson suggests that the obligation be limited to some ascertainable amount, such as five percent of the subsidiary's liabilities or existing capital requirements.²⁸⁵

In exchange for the enhanced obligation of the holding company, Professor Jackson's plan would relieve holding companies from the existing burdens of less efficient forms of enhanced obligations, such as high capital requirements.²⁸⁶ To avoid the problem of creating two classes of financial institutions—one backed by its shareholders and the other not—Professor Jackson would require that all institutions arrange for the satisfaction of the enhanced obligation either through the performance of a holding company with the financial capability to make good on the obligations or through the establishment of other guarantors, such as the insurance industry.²⁸⁷

The biggest problem with Professor Jackson's approach is the matter of mandatory capital requirements. The serious capital standards that banks face have created great incentives for bank holding companies to monitor bank activity and may even have overcorrected the moral hazard problem.²⁸⁸ Professor Jackson seems to agree²⁸⁹ but thinks the mandated capital requirements are too high. Unfortunately, U.S. banks are bound to comply with rigorous capital requirements²⁹⁰ which in turn are imposed in accordance with an international agreement, the Basle Accord.²⁹¹

In light of these stringent capital requirements, holding companies already have the motivation they need to monitor bank management. The mandated equity investment creates a great incentive for holding companies to carefully monitor and manage risk taking at the

283. See Jackson, *supra* note 24, at 513 ("Unlike many traditional regulatory strategies, which depend on government officials to anticipate and prevent high-risk activities, enhanced obligations look, in the first instance, to financial holding companies to monitor and restrain risk-taking in their regulated subsidiaries.").

284. See *id.* at 570.

285. See *id.* at 616.

286. See *id.* at 616-17.

287. See *id.* at 617-18.

288. See Gouvin, *supra* note 32, at 318-19.

289. See Jackson, *supra* note 24, at 587 ("Increased capital requirements mitigate the moral hazard problem because they increase the stake that investors other than public claimants hold in financial institutions.").

290. See *id.*

291. See HAL S. SCOTT & PHILIP A. WELLONS, *INTERNATIONAL FINANCE: TRANSACTIONS, POLICY AND REGULATION* 257-89 (4th ed. 1997) (providing a history and overview of the Basle Accord and commentary regarding the impact of the Accord on the banking industry).

bank, a point which was well understood by the banking regulators when the enhanced capital proposals were being considered.²⁹² Although increased capital requirements raise some potential problems, especially determining how large a capital reserve is necessary and ascertaining whether those capital requirements have been met,²⁹³ they appear to be for better or for worse a permanent part of the regulatory landscape. Especially in light of international agreements, the capital requirements are not going to change for U.S. banks. While a proposal like Professor Jackson's, which calls for less regulatory precision than an accurate determination of the "right" amount of capital, may in some ways be preferable to a mandated capital standard, in the real world, banks will have to live with the capital requirements as they exist.

I also do not agree that holding company liability can ever be properly calibrated, even theoretically, as Professor Howell has suggested.²⁹⁴ Given the apparently chaotic²⁹⁵ nature of the financial services market, it must be recognized that all regulatory devices employing holding company liability inevitably will be blunt instruments, and the ramifications of their implementation will be impossible to predict accurately.²⁹⁶ Policymakers and bankers should just live with that fact. The quasi-agency approach leaves it to the regulators to set the capital requirements at appropriate levels to provide for the range of claims against the bank, with liability for the holding company only when the subsidiary bank fails to discharge a duty owed to nonshareholders. The overall effect of the change should be to reduce potential liability for bank holding companies owning well-run banks, thereby reducing the cost of capital and achieving some of the same

292. See U.S. TREASURY DEP'T, MODERNIZING THE FINANCIAL SYSTEM, *supra* note 78, at 12 (expressing the view that increased capital is the "single most powerful tool to make banks safer" and that "banks are less likely to take excessive risk when they have substantial amounts of their own money at stake").

293. See Jackson, *supra* note 24, at 587-89.

294. See *id.* at 599.

295. Here, I am using the term "chaotic" in its mathematical sense to mean a complex non-linear system whose output is dependent on a complicated array of initial inputs and whose output is extremely sensitive to the value of these inputs. See JOHN ALLEN PAULOS, BEYOND NUMERACY: RUMINATIONS OF A NUMBERS MAN 32-37 (1991). For a discussion of chaos theory and legal theory, see Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641 (1996) (discussing chaos theory, path dependency, and efficient evolution as paradigms for thinking about the development of legal rules); for a general introduction to the topic of chaos theory, see generally JAMES GLEICK, CHAOS: MAKING A NEW SCIENCE (1988).

296. Borrowing from the classic illustration of a chaotic function, a change in one input to a chaotic system, such as a change in regulatory costs, could have surprising effects on the outcome of the system. The classic example is the so-called butterfly effect, positing that in a chaotic system like the weather, the output is dependent on the initial inputs such that a butterfly flapping its wings in Peking might be responsible for a tornado that strikes the United States. For all we know the function that defines the price of rice in Peking could depend on the extent of holding company liability in U.S. banking corporations and vice versa. Cf. PAULOS, *supra* note 295, at 33-34.

relief sought by Professor Jackson, but within the confines of the existing capital scheme.

B. *Enhanced Cross-Guarantee Provisions*

In another approach, Professor Havard also thinks that the regulatory scheme should include broad latitude to reach holding company assets.²⁹⁷ In her view, however, the attempts by the Congress and the regulators to shift the risk of loss from failed banks onto bank holding companies has come up short.²⁹⁸ While she sees the prompt corrective action provision of the Federal Deposit Insurance Corporation Improvement Act (FDICIA)²⁹⁹ requiring bank holding companies to file capital restoration plans to be a step in the right direction,³⁰⁰ she finds key provisions to be vague,³⁰¹ potentially leading to trouble in enforcement. More importantly, however, she finds the lack of a provision requiring the holding company to guarantee the capital restoration plan to be "ineffective and unfair" in those situations where a holding company has exploited the subsidiary bank.³⁰²

To remedy this failure, at the time that prompt corrective action would be appropriate, i.e., when the bank becomes capital deficient, Professor Harvard would inquire into the extent to which the holding company has treated the bank subsidiary as part of a larger enterprise or otherwise failed to respect its independent legal status.³⁰³ Her approach rests on a regulatory justification that appears to be an amalgamation of the hungry wolf and enterprise liability justifications for holding company obligations. Under her proposal, the federal banking regulators would not have unconditional access to the entire pool of holding company assets, but instead the holding company would be liable only when such liability is warranted by improper domination of the subsidiary by the parent. If the regulators find sufficient control, she would give the regulators the authority to require the consolidation of all the holding company's banking subsidiaries into one functional bank.³⁰⁴

297. See Havard, *supra* note 28, at 2358.

298. She points out that the source of strength doctrine may be beyond the authority of the Federal Reserve Board, *see id.* at 2383-85, and that some regulatory agreements may be unenforceable. *See id.* at 2372-75.

299. 12 U.S.C. § 1831o (1994).

300. See Havard, *supra* note 28, at 2386.

301. *See id.* at 2388-90.

302. *See id.* at 2390-91.

303. *See id.* at 2408-11. To determine if the parent's domination was improper, she offers several factors that she considers relevant to the inquiry:

(1) whether the parent company refers to all of the subsidiaries as a unit of the parent; (2) whether the parent company is responsible for the policymaking of all of the subsidiaries; (3) whether the parent company owns a majority of stock in all of the subsidiaries; (4) whether the parent company and the subsidiary have common officers and directors; and (5) whether the parent company directs the daily operation of funds management.

Id. at 2409.

304. *See id.* at 2398-2402.

Unfortunately, inquiring into subsidiary "independence" may not prove to be profitable. As I have discussed elsewhere, it is unrealistic to expect subsidiary directors to behave in a way that is truly "independent" of the parent's interests.³⁰⁵ Professor Havard's approach does, however, offer some worthwhile wrinkles in the bank holding company liability scheme. Focusing on the quality of the relationship between the bank and its parent is a good idea. But her approach does not go far enough. The quasi-agency approach is more promising because it assumes that the directors will act in the parent's interest and subject to the parent's control, thereby eliminating the need for a multifactor, fact-intensive inquiry. The quasi-agency approach only imposes duties on the parent that the bank directors have to nonshareholder constituents. Implicit in this approach is the idea that the holding company has benefitted from the subsidiary bank's failure to carry out nonshareholder duties and should therefore be liable for the damages caused by the dereliction of duties. By striking this balance, the quasi-agency approach achieves the underlying goal of Professor Havard's approach.

A second concern that plagues Professor Harvard's approach is the likely demise of the multibank holding company.³⁰⁶ While she would combine the holding company's bank subsidiaries to make one functional bank all the assets of which would be available to the regulators, she does not deal with the changes in branching and interstate banking that may presage the end of the multibank bank holding company era.³⁰⁷ As of the end of 1994, there were no more unit banking states and only two states that did not permit branching on a state-wide basis.³⁰⁸

Another criticism of Professor Havard's approach is that it would cause otherwise solvent banks to fail merely because one of the banking units is in trouble. In a sense, this is what happens now under the existing cross-guarantee provisions.³⁰⁹ It would seem to make more sense to impose a duty on the holding company to make good the damage done and let the holding company figure out where the resources to satisfy that obligation would come from.

305. See Gouvin, *supra* note 32, at 289-94.

306. See *supra* note 19 and accompanying text.

307. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338 (codified throughout 12 U.S.C.), permits nationwide branching after June 1, 1997, thereby negating the requirement that holding companies operating in several states have a bank chartered in each of those states. See *supra* notes 3-4 and accompanying text.

308. See Amel, *supra* note 2, at 3.

309. Exactly this situation unfolded when the Bank of New England collapsed in the late 1980s. Under the cross-guarantee provisions, BNE's healthy sister bank, Maine National Bank, was served with an assessment to make good the costs that the FDIC anticipated in bailing out BNE. The assessment was sufficient to render Maine National, which until that point had been a relatively solid institution, insolvent as well. See William F. Sheehan & Celestine R. McConville, *FIRREA's Cross-Guarantee Provisions, Solvent Banks, and the Fifth Amendment*, 112 BANKING L.J. 574, 575-76 (1995).

C. *True Enterprise Liability*

If the goal is to ensure that every claimant of a failed bank has recourse against as many resources associated with the banking activity as possible, a scheme should be employed by which the entire holding company is regarded as one economic unit, and the formal legal distinctions between and among its various affiliates are treated as mere technicalities. This is essentially the approach embraced by Professor Broome. In her view, the whole bank holding company structure should be treated as one enterprise and the legal distinctions between the corporate forms should be ignored.³¹⁰ Her proposal is designed to remedy what she perceives to be a failure of the current regulatory scheme to eliminate the moral hazard problem, as revealed in the following passage:

[T]he new statutes still contain limits on bank holding company liability, although the limits are larger than under the prior scheme. The closer the insolvent bank's negative net worth is to the liability limit, the more likely the bank holding company is to encourage bank managers to engage in risky activities at the FDIC's expense. The bank holding company again becomes indifferent about the amounts of bank insolvency loss in excess of its own liability.³¹¹

Although she notes that banks will have little incentive to seek prompt closure of an insolvent bank³¹²—a debatable point given the liability limitation rules in the prompt corrective action provisions³¹³—she does little to explain why the banking regulators will not act quickly to close insolvent institutions as they have been authorized to do by FDICIA other than to note that the decision to close an institution is fraught with political considerations.³¹⁴

Professor Broome's proposal to create what she calls "Holding Company Family Liability"³¹⁵ amounts to open-ended liability for a bank holding company and all its subsidiaries (both those engaged in banking and those in nonbanking businesses) for the costs of bank failure. She quickly dismisses the criticisms of commentators who argue that such a scheme is too inconsistent with traditional notions of corporate entity law³¹⁶ without making any attempt to rationalize

310. See Broome, *supra* note 29, at 996-97 (describing the "holding company family liability provision").

311. *Id.* at 991.

312. See *id.* at 953-55.

313. See 12 U.S.C. § 1831o(e)(2)(E) (1994). By guaranteeing a subsidiary's obligation under a capital restoration plan a holding company limits its direct liability for the institution's failure to the lower of either "an amount equal to 5 percent of the institution's total assets at the time the institution became undercapitalized" or "the amount which is necessary (or would have been necessary) to bring the institution into compliance with all capital standards applicable" at the time the institution failed to comply with the plan. *Id.*

314. See Broome, *supra* note 29, at 955.

315. See *id.* at 996-97.

316. See *id.* at 984-87.

banks' extensive capital requirements with a scheme where even well-capitalized banks that ultimately fail automatically create liability for their shareholder. In explaining why disregard of corporate entities is appropriate in the bank holding company context, Professor Broome falls back on a hybrid version of the discredited "specialness" argument and the controversial cost-defraying hypothesis: "[a] bank subsidiary's failure . . . 'imposes an external cost on the public by increasing FDIC losses and depleting the insurance fund,' so government intervention into the normal limited liability scheme is justified."³¹⁷ She does not, however, offer any argument in response to the many criticisms of the specialness and cost-defraying justifications,³¹⁸ nor does she explain why bank failure should be treated differently from the failures of other enterprises. If a key subsidiary of a commercial holding company were to fail, for example, the Miller Brewing Company subsidiary of Philip Morris, it certainly would create a negative externality for the public through higher beer prices and higher unemployment, which translates into higher crime, higher public assistance costs, and other tax supported expenses. Yet, it would be highly unlikely that the government would seek to recover those costs from Philip Morris, Miller Brewing Company's corporate parent.

For Professor Broome's terse justification for disregarding legal entities in the banking context to stand, it must establish that there is something "special" about banks that requires treatment deviating from regular corporate practice. However, as discussed above, the arguments in favor of bank specialness have not been especially persuasive.³¹⁹

Professor Broome's proposal never explicitly articulates the regulatory justification that animates it. She seems primarily motivated by the market discipline hypothesis because she seeks to eradicate all limitations that the holding company may enjoy from complete and total liability for the failure of the bank.³²⁰ Yet, she does not appreciate the limits of the market discipline approach to prevent bank failure.³²¹ Her proposal will not prevent banks that fail for macroeconomic reasons from failing, nor will it prevent managerial abuse that is effectively hidden from holding company oversight. What it will do is cause financial distress, if not failure, of brother-

317. See *id.* at 985 (quoting William R. Keeton, *Bank Holding Companies, Cross-Bank Guarantees, and Source of Strength*, FEDERAL RESERVE BANK OF KANSAS CITY ECONOMIC RESERVE, May-June 1990, at 55).

318. See *supra* notes 51-82 and accompanying text.

319. See *supra* note 54 and accompanying text.

320. See Broome, *supra* note 29, at 1000 ("The family liability proposal, however, places no artificial limits on a holding company's liability. The only moral hazard remaining as the result of limited shareholder liability under the family liability proposal is that as the bank holding company itself approaches insolvency, with little or nothing to lose, it will be tempted to engage in risky activities with the possibility of sufficiently high returns that its shareholders will regain some value in their holding company investment.").

321. See *supra* notes 91-115 and accompanying text.

sister businesses within the holding company structure merely because one subsidiary got into trouble. It will also result in the shareholder of that failed institution losing both its substantial capital investment and the value of all of the deposit insurance premiums paid because in a sense the deposit insurance will become illusory—the holding company will become the insurer of the deposit whether it played a role in the failure of the bank or not.

The quasi-agency approach resolves these problems by according the corporate entities an appropriate amount of respect and by supplementing that respect with enterprise liability principles when the bank's directors have acted in the holding company's interests to the exclusion of other constituents to which they owed a duty (including a duty to the bank itself as a legal entity). Professor Broome's concern about holding companies' "avoidance" of their obligations under current law would also be addressed by a quasi-agency approach. The holding company would be liable for the breach of duties owed to nonshareholder constituents whenever they occurred (limited by relevant statutes of limitation). So, selling a bank just before it becomes insolvent would not release a holding company from liability, which is another concern of Professor Broome's.

D. Double Liability for Shareholders

Historically, both state and federal banking law statutes imposed "double liability" on bank shareholders as a way to provide protection for parties with claims against the bank.³²² The "double liability" was typically limited to the par value of the shares, but it was nevertheless an amount above and beyond the actual money invested by the shareholders in the bank.³²³ In this way, the law provided a way for persons with claims against a failed bank to recover at least a portion of the amount owed by the institution in excess of its assets and capital. Although the scheme was designed to protect depositors and other fixed claimants, in the aftermath of the Great Depression it was widely perceived to have failed in that goal and was supplanted by government sponsored deposit insurance.³²⁴ After the double liability rule for national banks was repealed in 1959, the state statutes fol-

322. See generally John R. Vincens, *On the Demise of Double Liability of Bank Shareholders*, 12 BUS. LAW. 275, 275-76 (1957) (providing an overview of the rise and decline of the double liability idea).

323. Typical was the provision that used to be part of the National Bank Act, which read: "The shareholders of every national banking association shall be held individually responsible, equally and ratably, and not one for another, for all contracts, debts and engagements of such association to the extent of the amount of their stock therein, at the par value thereof, in addition to the amount invested in shares."

Id. at 275 (quoting U.S. REV. STAT. § 5151 (1875) (repealed 1959)).

324. See BLUMBERG, SUBSTANTIVE COMMON LAW, *supra* note 116, at 49.

lowed suit and the double liability of bank shareholders became a dead letter.³²⁵

Professors Macey and Miller have argued that double liability statutes provided an effective method for appropriately shifting bank failure loss to its owners and should be reconsidered as a regime for bank failure liability.³²⁶ Professors Macey and Miller's argument rests firmly on the moral hazard justification for holding company obligations and builds on their earlier work examining the moral hazard problem in banking, especially as exacerbated by deposit insurance.³²⁷ According to Professors Macey and Miller, U.S. banking policy "took a wrong turn when it abandoned double liability for a system of governmentally administered deposit insurance."³²⁸ In their view, double liability statutes provide an excellent method of correcting the moral hazard problem by creating incentives for bank managers to lower risky activities or suffer personal liability.³²⁹ They point to historical data to support the proposition that double liability was an effective check on bank managers' behavior, noting especially that before the advent of deposit insurance there were many more voluntary bank liquidations than involuntary.³³⁰ After reviewing the empirical evidence and concluding that double liability was a success, Professors Macey and Miller draw the inference that the double liability works because the potential personal liability of the shareholders serves as "supplemental off-balance sheet capital" that the claimants against the bank took into account even though it was not reflected on the banks' balance sheets.³³¹ Later studies have shown that double liability banking regimes in which creditors may recover from bank shareholders had the effect of reducing the costs of banking, perhaps by reducing the risk premium demanded by creditors.³³²

Although Professors Macey and Miller found the double liability regime to be an effective counterweight to the moral hazard problem, they readily recognized the many shortcomings of the approach as well, including such drawbacks as determining the assessment amount, identifying the persons liable for assessment, limiting administrative discretion, enforcing the assessments in group settings and with foreign investors, and adjusting the assessment to take into account fun-

325. See *id.*

326. See Macey & Miller, *supra* note 30, at 35.

327. See Jonathan R. Macey & Geoffrey P. Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153, 1162-65 (1988) (discussing the perverse incentives created by deposit insurance that move bank managers toward increasingly risky activities that result in a transfer of wealth from the nonshareholder claimants to the shareholders of the bank).

328. Macey & Miller, *supra* note 30, at 32.

329. See *id.* at 33.

330. See *id.* at 34.

331. *Id.* at 35.

332. See Lewis T. Evans & Neil C. Quigley, *Shareholder Liability Regimes, Principal-Agent Relationships, and Banking Industry Performance*, 38 J.L. & ECON. 497, 502-03 (1995).

damental corporate changes.³³³ What they did not examine was the problem that the double liability approach continues to hold equity-holders liable even when the bank fails for macroeconomic reasons unrelated to management misconduct. Nor does a double-liability regime square very well with capital requirements as they are currently implemented. It would make little sense to spend a great deal of regulatory time and effort trying to determine the level of satisfactory capitalization only to then hold shareholders personally liable when the mandated amount of capital proves insufficient after all. Finally, the objections raised above³³⁴ regarding the market discipline hypothesis must be addressed in the context of double-liability schemes, especially the limits on the ability of the equity holders to monitor their managers effectively.

The quasi-agency approach strikes a better balance than double liability because it is not limited to an artificial amount of extra liability, such as the par value of the shares, when the actual damages owing to those harmed may far exceed that amount. At the same time, the amount owing under the quasi-agency approach could be much less than the artificial amount available under the double-liability scheme. The flexibility afforded by the quasi-agency approach to provide recompense only for those who were harmed by the failure of the directors to discharge their duties is an important feature of the scheme.

V. CONCLUSION

Banking regulation in the United States for many years has found various ways to impose liability on bank holding companies when bank subsidiaries fail. Unfortunately, public policy never offered a coherent and compelling justification for these enhanced obligations. Assuming there may be occasions when imposing liability on holding companies may be appropriate, the imposition of liability should only occur where the bank subsidiary's directors owed a duty to a non-shareholder constituent (including the bank as a bank) and failed to discharge that duty properly. In those situations, the duties that the subsidiary directors should have carried out should be imposed directly on the holding company. The amount of damages owing should be limited to harms caused by failure to discharge the duties.

This approach to bank holding company liability, which I call the quasi-agency approach, provides a better mechanism to strike a balance between bank liability and holding company liability than the competing approaches to this problem that have been offered in the past. The other approaches all miss the mark of striking the right balance because they are grounded in regulatory justifications that do not

333. See Macey & Miller, *supra* note 30, at 39-55 (discussing each of these shortcomings).

334. See *supra* notes 91-115 and accompanying text.

withstand close scrutiny. The quasi-agency approach corrects the shortcomings of the earlier proposals.

As we enter the twenty-first century, we must take an important look at the crucial topic of holding company liability. If the United States expects its banks to effectively compete in the financial services marketplace of the future, regulators must rebalance the amount of liability imposed on bank holding companies for bank failure. If not, the cost of owning a U.S. bank will be relatively more expensive than owning other banks and banks in the United States could suffer a competitive disadvantage.